Real Estate Board of
New York

Federal Income Tax

and its

Relation to Real Property

Prepared on behalf of and published
for the members of the
REAL ESTATE BOARD
OF NEW YORK

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217 Broadway, N. Y.

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FOREWORD

The Committee on Publication of Federal Income Tax Information, of the Real Estate Board of New York, is confident that this volume will be of great value to the members. Its publication comes at a time of great uncertainty as to a federal plan of taxation for 1921. There is every reason to believe, however, that no matter what new source of revenue will be invoked to take the place of the Excess Profits Tax, the Income Tax on individuals and corporations will of necessity have to be continued. Under such circumstances, the present problem of interpreting when and under what circumstances profit or loss accrues to a taxpayer, must continue to receive the serious attention of the members of our industry. That our industry has its own unique problems, is self-evident.

Realizing that the administrative features of the Federal Legislation, such as procedure in connection with making returns, claiming abatements and refunds, etc., are accessible to all members through private publications of financial institutions, the contents of this volume has been limited to those unique problems which relate solely to real property and which heretofore have never been separately collated and published. Lack of space, moreover, has prevented the publication in this volume of many regulations incidental to real estate but not of prime interest to members of this Board; for example, situations affecting farm lands, standing timber, orchards, etc.

The Committee on Publication of Federal Income Tax Information was ambitious to make this study most comprehensive. It knows that what is here offered is the only study of its kind which has been made in the country. It regrets the necessity of limiting

the scope of the volume's usefulness in the manner described in the preceding paragraph. This compromise suggests itself—namely: that if individual members of the Board wish further light on the application of any of the *principles* underlying the rules, regulations and decisions contained in this volume, or perhaps even purposely omitted therefrom, they may call upon the Executive Secretary of the Board, who will endeavor, within reasonable limits, to be of as great assistance and help as is feasible and practical. This offer is made with confidence that the membership will not interpret the same as implying that the Board's offices may be invoked to go into specific facts or assist in the preparation of individual returns. Nevertheless, if a tax problem arises, it is desired that the entire membership know that the Committee is desirous of cooperating.

Besides the necessity of keeping this volume within its present limited space, another consideration for limiting its size is based upon the desirability of placing this study in the hands of the Members of the Board before the end of the present year. It is realized how necessary it is to have before each tax-payer, the law and regulations so that he may be in possession of all necessary information before closing his books of account for the taxable year. Instances are known where the premature and ill-advised closing of books has resulted in unnecessary embarrassments.

Committee on Publication of
Federal Income Tax Information,
JOHN M. STODDARD, *Chairman,*
WALTER STABLER,
WILLIAM C. DEMOREST,
CHARLES G. EDWARDS.

GREENBAUM, WOLFF & ERNST,
Counsel to Committee.

New York City, December, 1920.

LETTER OF TRANSMITTAL FROM COUNSEL TO COMMITTEE.

New York, December 24, 1920.

Gentlemen:

Pursuant to your request, we have compiled official documents relating to real estate problems arising under the present Federal Income Tax Law. We submit same herewith, together with certain explanatory comments.

This report has two main divisions. On the one hand, the official rules, regulations, decisions, opinions and orders of various Government officials or Boards (See Part V), and on the other hand, unofficial explanatory comment on this official data (See Parts I to IV). The statute provides that "the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, may make all needful regulations for the enforcement of the provisions" of the statute. Such regulations naturally express the best judgment of the Department officials, and they are entitled to and receive respectful consideration by the courts. However, while each tax-payer should recognize that these regulations are the sincere and painstaking efforts of trained authorities, caution must be exercised in applying any general regulations to a specific state of facts. What often appears to the tax-payer as an insignificant detail, may be the determining factor in the application of the statute, or the rulings thereunder, to the facts at issue.

We have collated in this volume substantially all of the official data on the specific problems affecting real estate. It would have been comparatively an easy task to have prepared a volume of five hundred pages. An almost insurmountable difficulty arose out of the necessity for condensing this study within its present page limitation. Accordingly, much that might have been said and per-

haps much that should have been said in order to meet the requirements of all members of the Board was necessarily omitted, and emphasis only has been placed upon those provisions of the law which were of greatest importance or on which regulations and decisions were in a rather complicated or confused condition. It has therefore been decided, although reluctantly, to omit matters of paramount importance perhaps to some individual member of the Board merely because the particular problem presumably did not affect many of the members of the Board.

Part V of this compilation consists of a reprint of those sections of the law which are fundamental to the problem or indicate the basis for the subsequent regulations and opinions. The formal interpretation of the present Revenue Act of 1918, by the Commissioner of Internal Revenue, is found in the volume known as Regulations Number 45. The pertinent Articles of these Regulations will be found in Part V. A few excerpts from the earlier volume of Regulations (Number 33) still applicable to or throwing light upon the present statute have also been inserted. From time to time the Commissioner adds to, amends or modifies the formal regulations. These later pronouncements are in the form of Treasury Decisions and of these the pertinent ones have been incorporated. Where no identification mark appears, the insertion is from the law itself.

In Part V, the following index will serve to indicate the source and character of the various pronouncements.

T. D. .... Treasury decision.
Op. A. G. .... Opinion of Attorney General.
O. or L. O. .... Solicitor's law opinion.
Sol. Op. .... Solicitor's Opinion.
S .... Solicitor's memorandum.
T. B. R. .... Advisory Tax Board recommendation.
T. B. M. .... Advisory Tax Board memorandum.

A. R. R. ....Committee on Appeals and Review recommendation.
A. R. M. ....Committee on Appeals and Review memorandum.
O. D. ....Office decision.

Two other sources have been employed:—a publication known as the Income Tax Primer for Farmers has been referred to under the initials "F. B." and a special bulletin published by the Department on the questions arising out of depreciation and obsolescence has been referred to as "F," its official designation.

A word of caution appears essential in connection with all of the matter contained in Part V except the excerpts from the law itself. First, any ruling or decision of the Department or of any of its bureaus may be revised without notice. Secondly, while the decisions of the Commissioner are entitled to great respect, and in the absence of court rulings the decisions are binding, it must not be lost sight of that in the final analysis, under our Constitution, the court and not the Commissioner or the Secretary of the Treasury decides on the meaning of laws and their application. Accordingly, it is of paramount importance that sooner or later (and this on patriotic as well as on material grounds) many mooted matters should be submitted to the courts for adjudication.

As a general principle of interpretation of tax legislation, comment should be made that all tax laws are interpreted in favor of the tax-payer, and ambiguous and inconsistent interpretations are strictly resolved against the taxing body.

The comment which has been added in this volume is prompted by a desire to explain in layman's language, certain of the more important regulations, to translate such regulations into bookkeeping terms and to stimulate, if possible, a more scientific, but still no less equitable tax thinking on the part of the tax-payers.

In the preparation of this volume, due thanks must be extended to those officers of the Treasury Department who painstakingly, though informally, have examined, in our behalf, the rulings quoted herein. In addition, we must express our appreciation to Mr. Walsh, of the Prentice-Hall Company, for the work performed by his organization in the tabulation of the Department's publications. Dr. Joseph J. Klein, C. P. A., of the accounting firm of Klein, Hinds & Finke, has conferred with your counsel on all matters relating to accounting problems discussed in this report. His organization has been of great assistance.

Very truly yours,

GREENBAUM, WOLFF & ERNST,

By: Morris L. Ernst.

Part I. Introduction

Chapter I. Bird's-eye View

(Pars. 1—13)*

The purpose of this introductory chapter is to present a bird's-eye view of the Federal Income Tax Law with particular application to the interests of those engaged in the real estate industry. The law attempts to determine what is known as taxable net incomes and to impose a tax on the amount thereof. This taxable net income is ascertained by subtracting what is known technically as "deductions" from so-called "gross income." In general, gross income consists of those items which the business man ordinarily refers to as gains, profits and proceeds of sales. The deductions are the business man's familiar expenses, cost of doing business and cost of sales, together with special items of losses. Gross income is defined in the law, as are also "deductions" and "net income."

The items which constitute gross income are discussed in as much detail as available space permits in Chapters II to V. As can be seen, the headings of these chapters correspond to the groupings of ledger account classifications which ordinarily embody the items that constitute gross income.

Chapters VI to VIII similarly dispose of the ordinary items of expense, cost and loss. But as this publication is to be of special assistance to those engaged in the real estate industry, a number of items peculiar

*References are to paragraph numbers in Part V of this book.

to the activity of those engaged in real estate hav
been included. One such item which has appeared t
deserve special treatment is the following:—Th
Form of Ownership, as to which certain observations ar
contained in Chapter IX.

Part II. Gross Income

Chapter II. Proceeds From Disposal of Real Property.

(Pars. 201—249)

a. Ordinary Sales

(Pars. 201, 202, 203, 208, 220, 222, 224, 228, 230 to 237)

The simplest type of gross proceeds resulting from ıe disposal of real property is found when A, the wner of a parcel of real estate sells it for $100,000— ll cash. The bookkeeping entry is simplicity itself. ¦ross proceeds of the sale amount to $100,000. but nticipating the practical question which the transction raises, it must be pointed out that the net taxble profit may be entirely different from the arithıetical result obtained by deducting the cost from he proceeds. To illustrate: The taxable income will epend on whether the property was acquired before r after March 1st, 1913. Had the same property been cquired as a gift or by bequest, the taxable result ıight be entirely different. Finally in passing, if the roperty had originally been acquired as a result of an xchange for other property, the determination of the et taxable income would be different again.

A more complicated situation than that which reults from the disposal of property for all cash, arises ʼhen the property is sold subject to mortgage. To lustrate:—A sells his property for $100,000: $60,000 ash, the balance in the form of a purchase money rst mortgage of $40,000 without amortization, due in ve years and bearing semi-annual interest at 5%. The

law and the regulations require A to account for gross income amounting to $100,000, despite the fact that part of the sales price would not be received for five years. A still more complicated situation arises when, as part consideration, A accepts a second mortgage bearing 6% interest. The regulations permit the determination of the fair market value of that which is received in exchange for property disposed of. The question naturally arises as to the fair market value of a second mortgage bearing 6% interest and due, in say, 5 or 10 years. The regulations are silent on this point. It is the writer's opinion, however, that if the fair market value of the mortgage can be determined by bona fide quotations or appraisal or otherwise, that instead of reporting as gross income the full face value of such second mortgages, the market value may be employed. This principle has been approved by the department in connection with appraisal of notes.

b. Sales on Installment Plan

(Pars. 209 to 211, 215, 217, 218, 221)

A further complication arises in case the property in question was sold on what is known as the installment basis. The Department has endeavored to provide relief in such situations. In the first instance, the tax-payer must ascertain whether or not a particular transaction is an installment transaction. This is determined in part by an examination of the relationship between the cash received at the time of closing, and the total sale price, and in the second place, by the examination of the method and due dates of the payment of the balance of the purchase price. A further factor is the type of collateral received by the seller. The regulations set forth that in order to come

within this classification, the initial payment must generally be less than one-quarter of the sale price. The different payments must be numerous and spread over a substantial period of time. It has not yet been decided definitely, whether the determination of the substantiality of the initial payment requires a comparison between the initial payment and the total sale price, or between the initial payment and the equity of the seller. The regulations indicate the former practice. In brief, the department regulations in cases of installment sales, provide for a system of accounting which is neither the accrual nor the cash basis and in effect requires the taxpayer to allocate between cost and gross income the cash received, as and when received. Under these regulations income in many cases need not be reported in the year of the title closing but when received. The regulations should be carefully read as to the rule for apportionment of such cash receipts. The Department has extended these regulations to cover individual transactions.

A paradoxical result has accrued from this hybrid form of relief. The seller who takes his profits in a second mortgage payable in ten years without amortization often assumes greater risk but is afforded less relief than the seller who takes his profit in a three year mortgage, which mortgage is further strengthened by periodic reduction payments. The former must return his mortgage as gross income at the time of sale, the latter may account on the delayed basis—i.e. the installment plan. What the Courts would say to this inconsistency is a matter open to conjecture.

Attention must be called to the fact that what in ordinary business terms might be called an installment transaction, will not come under the provision of these

regulations if collateral given for the deferred part of the sale price is represented by good notes.

c. Sales of Lots
(Pars. 212, 216, 223)

Special regulations have been written to cover situations where a tract of land is sold in lots, and in such cases, the cost must be equitably apportioned to the various lots. The effect of this rule is that each parcel constitutes a separate transaction.

d. Exchanges
(Pars. 204 to 207, and 238 to 247)

The most difficult situation in connection with this entire topic arises when a piece of property is disposed of, the consideration being other property, or cash and other property. The Department has held by special decisions and regulations that the property received in exchange must be treated as the equivalent of cash to its full market value. The respective values stated cannot be necessarily controlling as that would invite the establishment of low figures resulting in losses or reduction of income. The necessity therefore arises of determining the true market value of the property received. Real estate operators have often expressed themselves as aggrieved at the Department's attitude in this connection. It must be admitted that there appears valid ground for holding that the exchange of such property as real estate cannot result in taxable income. This is due primarily to the fact that the value of such property cannot be determined in the manner of actively dealt in listed stock market securities. In its very nature the value of most parcels of real property is

unique. The very fact that according to immemorial custom, dealers in real estate have never closed their books on the basis of inventories after the fashion of dealers in merchandise, is prima facie evidence of the absence of ascertainable, reliable market values.

Merchants, in computing their net income, almost invariably "take stock," that is, they extend the value of unsold merchandise or stock-in-trade on hand at the expiration of the taxable year. It has not been customary for real estate dealers (their stock-in-trade being land and buildings) to close their books on the basis of the value of unsold merchandise (realty). The reason is known to most operators, namely, that there is no available medium which would enable the operator to determine the market value of his unsold parcels. This fact has often resulted in an apparent inequitable treatment of the operator who was unable to register his loss consequent upon a fall in the value of property, even when the fall was a permanent one.

Not too much weight can be given by the Department to the fact that contracts of exchange of real estate contain arbitrary figures of valuation. These figures are ostensibly supplied as a matter of convenience for other purposes and merely replace the fictitious "One Dollar consideration." As a matter of fact, in every exchange, even where the costs of the respective parcels to both parties are the same, each party assumes that he has benefited by the trade, though not necessarily in terms of taxable income. The writer's opinions on this point are not in conformity with the present regulations of the department and if pursued further must naturally lead to a suspension of computation and reporting of gross income until the parcel received in exchange has been disposed of for cash

or its equivalent. Were it not for the fluctuation in tax rates and the variation in tax-payers' annual incomes, there would be no practical difference between the position of the Department and the policy herein set forth. A similar application of the exchange theory is evidenced in transactions where property is distributed in lieu of cash dividends or where money is paid as compensation for services. The rule regarding the "fair market value" of the property so paid, applies.

e. Date Sale Takes Effect

(Pars. 213, 214, 219, 225, 226, 227, 229)

If a contract for the sale of property is entered into in November of one year, but the closing does not take place until the following January, it has been held that the accounting for gross income should be as of the closing date and not as of the contract date. This is proper even in case where "earnest money" is paid when the contract is entered into.

The case of Brewster v. Walsh, decided by the U. S. District Court, District of Connecticut, December 16th, 1920, if sustained in the Supreme Court, will revolutionize the entire status of taxable income insofar as concerns a substantial part of the real estate business. The gist of this decision is that enrichment through increase in value of capital investment is not income in any proper meaning of the term. The mere fact that property (in this case it was securities, not real property), has advanced in value between the date of its acquisition and sale, does not authorize the imposition of the income tax on the amount of the advance.

The fundamental principle inherent in English income tax legislation is for the first time receiving approval in this country.

The relationship of this decision to traders in real estate is only treated collaterally and the application to traders or dealers must be separately considered. The future course of this case must be watched by real estate interests with great scrutiny.

Chapter III. Proceeds From the Operation of Property

(Pars. 301—304)

The principal item of proceeds under this caption is, of course, rent income. Tax-payers who report on a cash basis account for the actual cash rental received: those reporting on accrual basis report rent due whether received or not. Other operating income results from services rendered tenants, as for example, supplying of light, telephone service, etc. The accounting for such income is simplicity itself. The amounts actually received or earned are treated as gross income.

The present rent legislation has injected a new difficulty, new at least in volume and proportion, and particularly pertinent to those tax-payers making returns on accrual basis. For example, B is the owner of an apartment house and the tenants have been sustained in the lower courts in their refusal to pay said B the full amount of rent charged. To make the problem specific, suppose the accrued monthly rental charged against the tenants is $10,000, whereas the amount allowed by the court is only $7,500. How shall B account for his gross income on December 31st? The Revenue Department's field auditors who are accustomed to use book entries as evidence, would undoubtedly insist upon B's reporting the full $10,000 monthly as gross income, because, while the lower court has ruled against the increase, there has not been an ultimate determination. In the writer's opinion, it would

be justifiable to assume that the taxpayer is bound to charge up on his books only that amount of rent allowed by the courts and not optimistically hold that there will be a final reversal of the lower court. In other words, it seems advisable to report on the basis of the rentals received and not on that which in all fairness should be expected.

Chapter IV. Proceeds From Operation of Leaseholds.

(Pars. 301—306)

The subject matter under this heading can best be treated under two general headings:—

(1) Where the lessee has erected on the leasehold property a structure which under the law and contract reverts to the owner of the land.

(2) Where the improved property constituting the original leasehold, is further improved by alterations on the part of the lessee.

In case the lessee erects a building on leased property, it was held until recently that the lessor receives no other income than that specified in the contract; that is, a monthly or a quarterly rent until the termination of the leasehold, when he must account for additional gross income based upon the then market value of the improvement erected by the lessee. At the present time, the Department holds that inasmuch as title passes to the lessor immediately upon completion of the building, unless specifically agreed to the contrary, the lessor receives income at the time when the improvement is completed to the extent of the fair market value of same. This recent regulation has resulted in much unrest in the real estate field. For example, just prior to the promulgation of the decision, a long term lease was entered into in the Wall Street district under which the lessee agreed to erect an improvement to cost not less than several million dollars. It appeared as though the lessor would be

called upon to account in his 1920 return for approximately the full cost of the improvement. A close reading of the decision, however, dispels the fear. In the writer's opinion, all that the courts have held and all that the Treasury Department's decision intended, was that the lessor was to account for income predicated on the difference between the value of the property unimproved and the value of the property improved subject to the limitation of the lease. In the particular instance in mind, the improvement was of no material benefit to the lessor, who could not enter in possession or enjoy income other than rent until the expiration of the lease. On the assumption that the building depreciated at the normal rate allowed by the Department, the present worth of the improved property compared to the market value of the property unimproved leaves no margin of appreciable gross income.

While not literally appropriate to this chapter, it appears desirable to refer to another deduction which, from the point of view of a tenant or lessee, is somewhat similar to destruction of property. We refer to the situation which arises when a lessee erects a building or makes improvement on leasehold property. Ordinarily the improvement of course, reverts to the owner at the expiration of the lease. Under Treasury Regulations in force, the tenant may write off as an expense and therefore treat as an allowable deduction, a ratable part of the total cost of the improvement, said part being determined by dividing the total cost equally among the term of years expressed in the lease, unless the improvement has a shorter lifetime, in which case the improvement may be written off during its life. For example, where partitions are erected which will last ten years, under a leasehold of twenty-five years, approximately ten per cent., and not four per cent. may be

written off annually. It would appear reasonable that if the owner of the property were to be charged with income upon the completion of the improvement that the lessee would be permitted a corresponding deduction. This is not the case, however, because the regulations regarding deductions have not been changed and the question has not been passed upon by the courts.

Just one other thought in connection with the problem: Suppose the tenant should abandon his lease, and therefore his improvement, prior to the termination of the lease and prior to writing off the full cost of his improvement. On general principles, it appears well settled that the balance not written off may be taken as a deduction during the year when abandonment takes place.

Where the lessee improves property enjoyed by him under the leasehold by the addition of fixtures, the repair of ceilings, the repainting of walls, etc., it has been held that no income results to the lessor until the termination of the lease. While this ruling is inconsistent with the one referred to in the preceding paragraph, it is still effective and must be assumed to control.

Under certain leaseholds, provision is made for the payment of a nominal sum in cash to the lessor, in addition to which the lessee makes payments of interest on mortgages, taxes and other fixed carrying charges. Even though the payment for these fixed charges are made direct and do not pass through the hands of the lessor, these items have been rightly held to be constructive receipts on the part of the lessor who must account for them in his gross income. Obviously, appropriate deductions are allowed the lessor.

Chapter V. Proceeds From Miscellaneous Sources

Naturally enough, every organization engaged in the real estate business, while it has problems peculiar to itself, shares in common with all other tax-payers, the common sources of income, as for example, interest on bank deposits, interest on universally held Government securities, etc. No specific mention is made regarding the treatment of such items. One item, however, under this heading, must be referred to somewhat at length. It is the problem that arises in connection with the purchase of a mortgage below par and bearing a fixed rate of interest. To illustrate: A $10,000, 6%, 5 year mortgage, interest payable semi-annually, has been bought for $9,000. Let us assume that there is no question regarding its payment at maturity. While the cash interest received each half year amounts to $300—and this is the amount which must be accounted for in gross income by the tax-payer who reports on a cash basis—the tax-payer who reports on the accrual basis must take another factor into consideration. Inasmuch as the mortgage increases in value from $9,000, the purchase price, to $10,000, the face or redemption value during its life time of five years, the increment is $200 per year, and this increment must be reported as gross income annually. On the other hand, the tax-payer who reports on a cash basis accounts for the $1,000 of profit in the year when the mortgage is redeemed. A different situation arises in the case of installment mortgages bought at face value where the interest and one-fifth of the face of the mortgage is payable each year. In such

a case, both classes of tax-payers report the same income each year, $600 of interest, and $200 of profit.

Another item which is sometimes believed to affect gross income must also be referred to. By the terms of certain leases, the lessor receives one or more years' rental in advance, to be held as security. Whether the tax-payer reports on accrual or on cash basis, this amount is not income until it is used as rent payment or as forfeiture.

Part III. Deductions From Gross Income

Chapter VI. Depreciation and Obsolescence.
(Pars. 401—416)

One of the most important and troublesome items in which the real estate owner is concerned, deals with the problem of depreciation and obsolescence. Depreciation may be defined as a loss resulting from the use to which a building is put. Under the tax law it applies to the building and its contents and not to the land. Under specific rulings of the Department, losses other than from use, wear and tear, are not recognized as depreciation factors. The principal item which is not recognized is the loss which results from change in neighborhood conditions due to zoning laws, natural developments or legislative enactments. One notable exception exists in the case of property constructed for a specific purpose, as for example, brewing or distilling, which becomes nonusable due to permanent legislative or industrial changes. In such cases a loss based upon the difference between the continued use value or salvage value and the corresponding book value, may be taken into consideration as a special obsolescence or depreciation deduction.

As to the ordinary rates of depreciation, the Department has not deemed it wise to publish rates as definite and fixed as those which have been issued as a result of the Wisconsin investigation. The real estate industry might well offer assistance to the Department in the compilation of such schedules. The Department apparently adheres to the 1918 principle that "the average us-

able life of a frame building is 25 years, a brick building 35 years, and a stone or concrete building 50 to 100 years." Of course, special consideration is given to extraordinary conditions, such as effects of vibration of heavy machinery, exposure to the elements, "use to which put," strain on party walls, etc.

The Wisconsin Report of 1919, sets forth annual depreciation in percentage as follows:—

Buildings.	Frame and veneered, per cent.	Brick and masonry, per cent.	Fireproof, per cent.
Sheds	7	....	....
Stables, etc.	4	3	....
Farm Dwellings	1.5	1.5	....
Other farm dwellings	2.5	1.5	....
City dwellings	2.5	1.5	1
Apartment houses	3	2.5	1.25
Stores	2.5	2	....
Stores with flats above	2.5	2	....
Warehouses	2.5	2	1.25
Elevators	2.5	1.75	1.25
Factories	5	3	1.25
Office Buildings	2.5	1.5	1
Hotels	2.5	1.75	1.5
Paper and pulp mills	...	2.5	2.

In the case of an apartment house on West 84th Street, New York City, as a result of a jury trial, 3% depreciation was allowed the tax-payer instead of his claimed deduction of 5%. It is the writer's experience that depreciation rulings bearing upon the estimated lifetime are too literally interpreted by tax-payers in cases where they become the owners of property erected previous to the date of their acquisition. For example, a brick building with an estimated life of 35 years, was erected in 1895 and acquired by Mr. C. for $500,000 in 1920. The "expectancy of life" of the property is now only 10 years. If it is a fact that $200,000 was paid for the land and, $300,000 for the building, then Mr. C. should be permitted to deduct not from 2% to 3%, but 10% of $300,000 each year.

The writer is of the opinion that a great majority of tax-payers have unwittingly failed to take full depreciation in such cases in prior years. A regulation in point was recently issued which provides that where insufficient depreciation was taken in prior years, a redetermination may be made on the basis of the depreciation exhausted and the balance of the life of the property. This regulation in part, however, is somewhat inconsistent with the doctrine enunciated in this paragraph.

The rates of the depreciation referred to above in connection with the life expectancy of a building do not apply to such items as boilers, engines, plumbing and other fixtures attached to the building on which in turn, depreciation may be based dependent upon the life of such fixtures. In every instance, the total depreciation to be taken is the difference between the cost and the salvage or residual value of the property depreciated. The relationship of repairs to depreciation is treated elsewhere.

When property is acquired by gift or bequest, depreciation is based upon the market value of the property as of the date of acquisition and the rate of depreciation is determined by taking into consideration the life expectancy of the property so acquired. The principle is similar to that which obtains when property is purchased from an owner who has been in possession during a part of the property's lifetime.

No depreciation is allowed on residences occupied solely by the owner. An appropriate depreciation is allowed, however, when the owner only partly occupies the premises, such depreciation being determined in a number of ways, the most common method being based upon the relative rental value of the property occupied by the owner compared to the total rental value.

The regulations provide that depreciation would be al-

lowed only in case it is charged off on the books of the tax-payer. The Department has consistently held that the charging off on the books is necessary on the ground that the tax-payer's return must be in accordance with his books and that if such charging off were not compulsory, it would increase the difficulties of the Department in auditing returns. The intention of the Department is entitled to full respect and it is the duty of every tax-payer to co-operate with the Department, but nothing in the law or rulings compels tax-payers to keep books of account and if the only record book of the taxpayer is his check-book, it is difficult to see how depreciation can be entered. It is possible that all that the Department would insist upon in such a case, would be a memorandum on the stub of the check-book on the date of December 31st and the writer recommends such a practice.

Chapter VII. Deductions Based Upon Destruction of Property

(Pars. 501—506)

The law provides that the taxpayer may deduct from gross income all losses occasioned by fire, flood, etc., when not compensated by insurance or otherwise. For example, if D's property is destroyed by fire and he carries no insurance, he can deduct as a loss the total cost provided the property was acquired during the year when destruction occurred. If the property was acquired during a prior taxable year, the full deduction would be ascertained by deducting from the cost, (unless acquired prior to March 1st, 1913), the depreciation charged off during the prior and the present taxable years, plus the cost of improvements and betterments, capitalized and not treated as an expense. If the property had been acquired prior to March 1st, 1913, the starting point in the calculation would be the market value as of March 1st, 1913.

Where fire or other loss occurs and insurance is carried, the total amount deductible by the taxpayer is the difference between the loss as ascertained in accordance with the suggestions contained in the preceding paragraph and the amount of recovery from the insurance company. Where the amount recovered from the insurance company is in excess of the book value of the property destroyed (because the market or replacement value of the destroyed property insured is greater than the cost), the excess of recovery over such book cost constitutes gross income to the taxpayer. There is this proviso, however, that the amount recovered by the taxpayer

may, under regulations of the Department, be employed for the purpose of replacing the destroyed property, in which event no gross income may result, although the book value of the property may be increased. The depreciation thereafter must be based upon the book cost and not upon the increased cost.

A somewhat anomalous situation arises where the taxpayer's residence, owned and exclusively occupied by him, is destroyed. Ordinarily, losses not incurred in trade or in transactions entered into for profit, do not constitute allowable deduction. An exception occurs in the case of non-business property such as residences of taxpayers destroyed. The amount of loss deductible is exactly the same as in the case of business property destroyed, the treatment of which was discussed in the preceding paragraphs.

It may be appropriate to discuss under this heading a situation which arises where an old building is removed prior to the erection of a new one. The average business man would regard the cost of removing the old building as an unrequited expense, but the Department has held that the cost of such removal cannot be taken as a deduction from income but must be capitalized by adding same to the cost of a new building. The cost of erecting the new building plus the cost of removing the old shall be made the basis of depreciation. Many who are affected by this ruling cannot see the equitableness of it and it is quite likely that the court may some day be asked to pass upon the issue.

The regulations create a conflict and apparently endeavor to distinguish between the removal of a building promptly after purchase and such removal at later dates.

Chapter VIII. Deductions Based Upon Miscellaneous Expenses and Cost.

In this chapter there is a brief discussion of only a few of the many items which might properly be included under this caption. Those excluded are in the main of the kind which are common to all business and not peculiar to the real estate industry.

(A) Taxes and Assessments
(Par. 508)

The law provides that all general taxes paid by the taxpayer except Federal income and profits taxes, shall constitute allowable deductions. There is just one other exception. Taxes paid for so-called local benefits of a kind tending to increase the value of the property are not allowed as deductions. It does not appear necessary to tell members of the Board what is meant by such assessments.

(B) Bad Debts
(Pars. 509—512)

The peculiar situation which has arisen out of the recent rent legislation has been discussed elsewhere. Ordinarily, taxpayers who report on accrual basis may deduct uncollectible rents, but those who report on a cash basis may not do so on the theory that no income has been reported except as received. The subject of "Bad Debts" also arises in connection with the foreclosure of mortgages and the failure on the part of the mortgagor to meet interest payments. With respect to uncollectible interest, the same rule applies as to uncollectible rent. Taxpayers who report on accrual basis may deduct uncollectible interest; others may not.

As to deduction under the heading of "Bad Debts" of sums uncollectible under bonds and mortgages, the Department has held that it is insufficient to procure a judgment evidencing the insufficiency of the collateral, namely the mortgage, but that it is encumbent upon the taxpayer to proceed against the bond. Naturally, the regulations cannot imply that legal proceedings are necessary in every case. The Department, however, must be satisfied that the obligation on the bond is worthless. Such evidence is similar to that necessary in order to establish losses on loans, accounts receivable, etc. As to compromise of indebtedness arising out of bond and mortgage transactions, little can be added to the ruling of the Department except that the facts in each specific case must be separately treated because ordinarily, losses resulting from compromise are not deductible. Members of the Board cannot be too strongly cautioned against entering into ill-advised compromises. In spite of the fact that a market value is definitely created the Department in unrecorded rulings has indicated that no loss is established in the case where the mortgagee buys in at sale the collateral. This, on the doubtful theory that the loss will only be established at the time of the sale of the collateral by the purchasing mortgagee.

(C) Repairs
(Pars. 513—514)

The cost of repairs constitute an allowable deduction. Where so-called repairs increase the value of the property, that portion of the expenditure which more than replaces old property, is not an allowable deduction but must be capitalized.

Field agents have often objected to repairs where depreciation has also been taken by the taxpayers. The regulations distinctly provide that both incidental

repairs and a fair depreciation may be treated as allowable deductions by the taxpayer, any rulings of revenue agents to the contrary notwithstanding.

(D) Contributions
(Par. 515)

It is generally known that contributions made to recognized charitable and educational associations and other like organizations are deductible up to fifteen per cent. of the taxpayer's net income. Unfortunately, when contributions are made by a corporation, deductions are not permitted, except in one case which need not be discussed in this connection. In a closed corporation, the usual type in real estate ownership, the stockholders individually rather than the corporation as an entity should make whatever contributions appeal to the organization. Contributions made by a partnership are not deductible as such, but the individual members of the partnership may consider the contribution as made by them individually in the same proportion as they share in profits and losses.

(E) Salaries

The allowance of salaries is no longer of moment, except in the case of corporations. Were it not for the variation between corporate and individual income tax rates the amounts of salaries to corporate officers would be immaterial. It is evident that because of the fact that real estate is conducted through so-called closed corporations, the matter of salaries to active officers has received scant, if any, attention. The amount of salaries paid are in no way standardized and it might well be to the benefit of the industry if the Real Estate Board conducted an anonymous inves-

tigation in order to ascertain the relationship of salaries paid to capitalization, gross profits and other determining factors. Elaborate and well reasoned regulations have been issued in regard to the disallowance of unreasonable salaries paid in approximate proportion to stockholdings. On the whole, the real estate trade has been most conservative in salaries paid to officers.

(F) Mortgage Expenses

Many taxpayers are only too familiar with the fact that in order to secure mortgages, bonus payments are necessary. The question of the treatment of such bonuses deserves brief mention. The situation ordinarily arises in connection with the payment of a commission to the broker who negotiates the mortgage. If the payment is made in this form, it is clearly an allowable deduction, in the year when incurred. If, on the other hand, payment of the bonus is complicated by other features and other arrangements, the treatment must be decided upon in each case by the facts as they develop. Finally, in this connection, F may be the owner of a $100,000 mortgage which he sells for $95,000. The loss incurred may be written off as an allowable deduction in the year when incurred.

Our attention has been called to the fact that some real estate operators who, under mortgage agreements with financial institutions, are compelled to make periodic payments on account of the mortgage, felt that they were not treated equitably in that, while such payments were necessary and mandatory, they could not be deducted from gross income for the purpose of determining taxable income. Of course, the ex-

planation is very simple. The payment on account of mortgage, even though necessary, constitutes a capital investment increasing the equity of the owner and has no relationship whatsoever to income.

(G) Sundries

(Pars. 501—522)

Various other sundry expenses are worthy at least of mere mention, such as payments made for termination of lease and the ordinary operating expenses of the business.

While members of the Board are, of course, not personally interested in the type of certain payments developed at the recent hearings of the Lockwood Committee, the question may be of passing interest. Where payments are made to "attorneys" for the purpose of settling a strike, the Department will undoubtedly hold that the item does not constitute an allowable deduction, but should be capitalized to increase the cost of the building. It may later be recouped through depreciation. If the payment is clearly in the nature of a "bribe" it is not allowable at all, not even for capitalization purposes. On the other hand, the "fee" paid to the attorney, or the "honorarium" to a labor agent, constitute income to these gentlemen.

Part IV.

Chapter IX. Forms of Ownership, Individual, Partnership, Corporation, etc.

(Pars. 101—112)

Because of reasons unrelated to tax legislation, real estate business, in the main, has been conducted through the use of corporations. Many problems in the initial organization of such corporations are of supreme importance, such as method of capitalization, distribution of stock, and so forth. Space does not permit the treatment of this phase of the question in this volume, nor more than a passing reference to the fact that with the increasing income, due to recent rental increase, especially in non-resident property, a serious situation has arisen, because of the original insufficiency of capital and the consequent heavy excess profits tax involved. Different types of organizations at times lessen heavy profit taxes.

Attention is called to the regulations of the Department, referring to joint ventures. Such joint ventures are often improperly called holding companies. The interested parties—though not partners—must make individual returns of income thereunder. Not only is joint ownership common in the real estate business as between individuals, but a still more complicated situation arises where either a joint ownership or a partnership is created between corporations.

As to those phases of the business such as brokerage and acting as rental agents, many real estate corporations fall into the classification of personal serv-

ice corporations. The effect of such classification, in brief, is to place the stockholders in a taxable status similar to that of partners. The Treasury Department has been inclined strictly to limit the number of personal service corporations. Attention is called to the fact that the status of a corporation in this respect is not fixed forever and that a corporation may, depending upon the facts, change from a capital invested corporation to a personal service corporation and vice versa.

Real estate brokers and agents operating through corporate entities are cautioned against conducting in such corporations business which requires capital—such as dealing in properties.

A most common practice in the industry is that a single operator or a group of interested persons divide their various holdings into separate and distinct corporations. Whether or not such corporations must file a consolidated return depends on the particular facts in the case under consideration. Whereas the intention of compelling consolidation of corporate returns was to prevent the evasion of taxes by the disintegration of holdings, the actual practical result has been to reduce taxability in many instances. In the real estate field particularly, the requirements as to consolidation of returns has provided substantial relief. This is due primarily to the fact that through the consolidation of corporate returns the losses of one corporation are balanced against the profits of the affiliated corporations.

Several rulings have been inserted in this volume which relate to problems primarily affecting estates holding or operating real property. These rulings include such problems as the reporting of profits resulting from

an executory contract if the seller dies before transferring title, annuities charged upon devised land, payments chargeable against an estate and, the treatment of income during administration.

An interesting form of apparent ownership through a corporation is created when G, the individual owner of a number of parcels, chooses not to incorporate them, but delegates the management to a corporation, under an arrangement whereby the managing corporation collects all rents from each of the properties, makes all necessary disbursements on behalf of the same properties and acts, in all respects merely as agent for the owner. In such cases the corporation files the ordinary corporation tax form but states upon the face thereof [illegible] agency relationship to the owner and the fact that its sole income consists of just sufficient funds to cover its expenses and that it is not operating for a profit and hence is not subject to income tax.

Part V. Government Documents

Chapter X. Excerpts from Revenue Act of 1918

(N. B. Only a few sections of the statute are printed below. Many correlated sections have been omitted. In interpreting the law, the entire statute must be read and construed in its entirety.)

Basis for Determining Gain or Loss

1 Law Sec. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.

(b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any;

but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value,

no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received shall be treated as taking the place of the stock or securities exchanged, and the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.

Inventories

2 Law Sec. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Net Income Defined—Individuals

3 Law Sec. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;

but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.

If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

Gross Income Defined

4 Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or

from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property;

also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or

gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured;

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);

. . . . . .

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

. . . . . .

Deductions Allowed

5 Law Sec. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and

including rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;

(2) All interest paid or accrued within the taxable year on indebtedness,

except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from taxation under this title as income to the taxpayer,

(3) Taxes paid or accrued within the taxable year imposed
(a) by the authority of the United States, except income, war-profits and excess-profits taxes; or

(b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 222; or

(c) by the authority of any State or Territory, or any county, school district, municipality, or other taxing subdivision of any State or Territory,

not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or

(d) in the case of a citizen or resident of the United States, by the authority of any foreign country, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 222; or

(e) in the case of a nonresident alien individual, by the authority of any foreign country (except income, war-profits and excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed), upon property or business;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business;

but in the case of a nonresident alien individual only as to such transaction within the United States;

(6) Losses sustained during the taxable year of property not connected with the trade or business

(but in the case of a nonresident alien individual only property within the United States)

if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise;

(7) Debts ascertained to be worthless and charged off within the taxable year;

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(9) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the producton of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the

present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income.

At any time within three years after the termination of the present war, the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by Title III for the year or years affected shall be redetermined; and

the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

. . . . . .

(11) Contributions or gifts made within the taxable year to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to the special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act, to an amount not in excess of 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary.

. . . . . .

Items Not Deductible

6 Law Sec. 215. That in computing net income no deduction shall in any case be allowed in respect of—

(a) Personal, living, or family expenses;

(b) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(c) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; or

(d) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

Partnerships and Personal Service Corporations

7 Law Sec. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or,

if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership.

. . . . . .

(d) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed.

(e) Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof:

Provided, That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.

. . . . . .

Law Sec. 200. The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived

from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive;

Law Sec. 303. That if part of the net income of a corporation is derived (1) from a trade or business (or a branch of a trade or business) in which the employment of capital is necessary, and (2) a part (constituting not less than 30 per centum of its total net income) is derived from a separate trade or business (or a distinctly separate branch of the trade or business) which if constituting the sole trade or business would bring it within the class of "personal service corporations," then (under regulations prescribed by the Commissioner with the approval of the Secretary) the tax upon the first part of such net income shall be separately computed (allowing in such computation only the same proportionate part of the credits authorized in sections 311 and 312), and the tax upon the second part shall be the same percentage thereof as the tax so computed upon the first part is of such first part: Provided, That the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined upon the entire net income, without reference to this section, as other taxes are determined under this title. The total tax computed under this section shall be subject to the limitations provided in section 302.

Estates and Trusts

8 Law Sec. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts.

The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that there shall also be allowed as a deduction (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is

during the taxable year paid to or permanently set aside for the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, or any corporation organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; and in cases under paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of each beneficiary's distributive share of such net income, whether or not distributed before the close of the taxable year for which the return is made.

(c) In cases under paragraph (1), (2), or (3) of subdivision (a) the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary.

except that in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary.

In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.

(d) In cases under paragraph (4) of subdivision (a),

and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary,

the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary his distributive share, whether distributed or not, of the net income of the estate or trust for the taxable year, or,

if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the estate or trust is computed, then his distributive share of the net income of the estate or trust for any accounting period of such estate or trust ending within the fiscal or calendar year upon the basis of which such beneficiary's net income is computed.

In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

Net Income Defined—Corporations

9 Law Sec. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the

gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

Gross Income Defined

10 Law Sec. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in section 213, ...

Deductions Allowed

11 Law Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and

including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

(2) All interest paid or accrued within the taxable year on its indebtedness,

except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation under this title as income to the taxpayer, or,

in the case of a foreign corporation, the proportion of such interest which the amount of its gross income from sources within the United States bears to the amount of its gross income from all sources within and without the United States;

(3) Taxes paid or accrued within the taxable year imposed

(a) by the authority of the United States, except income, war-profits and excess-profits taxes; or

(b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 238; or

(c) by the authority of any State or Territory, or any county, school district, municipality, or other taxing subdivision of any State or Territory,

not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or

(d) in the case of a domestic corporation, by the authority of any foreign country, except the amount of income, war-profits

and excess-profits taxes allowed as a credit under section 238; or

. . . . . .

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise,

(5) Debts ascertained to be worthless and charged off within the taxable year;

(6) Amounts received as dividends from a corporation which is taxable under this title upon its net income, and

amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed by Act of Congress;

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

. . . . . .

Items Not Deductible

12 Law Sec. 235. That in computing net income no deduction shall in any case be allowed in respect of any of the items specified in section 215.

Consolidated Returns

13 Law Sec. 240. (a) That corporations which are affiliated within the meaning of this section shall, under regulations to be prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income and invested capital for the purposes of this title and Title III, and the taxes thereunder shall be computed and determined upon the basis of such return:

Provided, That there shall be taken out of such consolidated net income and invested capital, the net income and invested capital of any such affiliated corporation organized after August 1, 1914, and not successor to a then existing business, 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive. In such case the corporation so taken out shall be separately assessed on the basis of its own invested capital and net income and the remainder of such affiliated group shall be assessed on the basis of the remaining consolidated invested capital and net income.

In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed

upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each.

There shall be allowed in computing the income tax only one specific credit of $2,000 (as provided in section 236); in computing the war-profits credit (as provided in section 311) only one specific exemption of $3,000; and in computing the excess-profits credit (as provided in section 312) only one specific exemption of $3,000.

(b) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated

(1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or

(2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

. . . . . .

Chapter XI. Regulations, Decisions, Opinions, etc.

Forms of Ownership

101 *Joint Ownership and Joint Adventure.*—Joint investment in and ownership of real and personal property not used in the operation of any trade or business and not covered by any partnership agreement does not constitute a partnership. Co-owners of oil lands engaged in the joint enterprise of developing the property through a common agent are not necessarily partners. In the absence of special facts affirmatively showing an association or partnership, where a vessel is owned by several individuals and operated by a managing owner or agent for the account of all, the relation does not constitute either a joint-stock association or a partnership. The participation of two United States corporations in a joint enterprise or adventure does not constitute them partners. (Art. 1507, Reg. 45, Rev., April 17, 1919.)

102 *Personal Service Corporation.*—The term "personal service corporation" means a corporation not expressly excluded, the income of which is derived from a professsion or business (a) which consists principally of rendering personal service, (b) the earnings of which are to be ascribed primarily to the activities of the principal owners or stockholders, and (c) in which the employment of capital is not necessary or is only incidental. No definite and conclusive tests can be prescribed by which it can be finally determined in advance of an examination of the corporation's return whether or not it is a personal service corporation. In the following articles are laid down the general principles under which such determination will be made. (Art. 1523, Reg. 45, Rev., April 17, 1919.)

103 *The Underlying Necessity for Consolidated Returns.*—The provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise even though the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations or where the stock of two or more corporations is owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the

direct ownership of the property, the investment capital and net income of the branch form a part of the invested capital and net income of the entire organization. Where such branches or units of a business are owned and controlled through the medium of separate corporations, it is necessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise opportunity would be afforded for the evasion of taxation by the shifting of income through price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return excessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group. (Art. 631, Reg. 45, Rev., April 17, 1919.)

104 *Whether Undivided Interests Upon Division Constitute a Sale.*—Where two persons own property in undivided interests and wish to divide said property by each taking his own share, would this be considered a sale of property and subject to income tax based on 1913 values? No. (F. B.—Q. 48.)

105 *Agreement to Sell by Decedent Completed by Executor. When Return to be Made.*—In April, 1919, A agreed to sell B his farm for $10,000, payment in full to be made in June, when B was to receive title and take possession. A died in May. Sale was completed by executor. Should the profit or loss be reported in the return for decedent or the return for the estate?

The executor should account for the profit or loss in the return for the estate covering the period from the date of death to the close of the taxable year. (F. B.—Q. 46.)

106 *Where Life Estate With Remainder, Remainderman's Acquirement is Coequal with Acquirement of Life Estate.*—Where real estate is devised by a testator to his widow for life with a direction that upon her death the property shall be sold and the proceeds divided among the testator's children, the basis for ascertaining the gain or loss on a sale of such real estate and distribution of the proceeds to the children is the value of their rights at the time they vested, or on March 1, 1913, if they vested prior thereto.

The possession of land devised to the children of a testator subject to a life estate in their mother, which vested in fact on the death of the life tenant, was acquired by the children *in right* on the death of the testator. The provision of the income tax law exempting from tax the value of property acquired by devise or bequest merely exempts the value of the right at the time it was acquired and not any value which subsequently may attach to it pending actual or anticipated arrival of the period of enjoyment. (33—20—1126, Sol. op.—35.)

.07 *Annuities and Insurance Policies.*—Annuities paid to religious, charitable and educational corporations under an annuity contract are subject to tax to the extent that the aggregate amount of the payments to the annuitant exceeds any amounts paid by him as consideration for the contract. An annuity charged upon devised land is income taxable to the annuitant, whether paid by the devisee out of the rents of the land or from other sources. The devisee is not required to return as taxable income the amount of rent paid to the annuitant, and he is not entitled to deduct from his taxable income any sums paid to the annuitant. Where an insured receives under life insurance, endowment or annuity contracts sums in excess of the premiums paid therefor, such excess is income for the year of its receipt. See article 72. Distributions on paid-up policies which are made out of earnings of the insurance company subject to tax are in the nature of corporate dividends and are income of an individual only for the purpose of the surtax. (Art. 47.)

.08 *Decedent's Estate During Administration.* A, in July, 1919, contracted to sell her farm. By the terms of the contract $2,500 was paid down, $8,000 was to be paid on March ., 1920, at which time deed was to be given and possession transferred, and the balance, represented by notes bearing 5 per cent. interest, and secured by first and second mortgages, was payable $20,000 in 1930, and $34,000 in 1935. The payment of $2,500 made at the time contract was signed was to apply on the total purchase price of the property. On September 4, 1919, pending the execution of the notes and mortgages, A died, leaving four children who are equal beneficiaries under her will.

Held, that no portion of the initial payment of $2,500 received by A in July, 1919, pursuant to the contract of sale is income to the decedent, and no portion of that amount is to be reported in her gross income for the period from January 1, 1919, to the date of her death inasmuch as it represents merely a deposit or earnest money to bind the contract, no sale of the property having actually taken place.

If the terms of the contract have been carried out and the property transferred to the purchaser prior to the termination of the administration of the estate, the executor will be required to report as income in the return to be filed for the estate for the taxable year 1920, the difference between the fair market value of the property at the date of the death of the decedent (such value to be based upon the value of the property as appraised for the purpose of the Federal estate tax) and the total price received for the property, the notes of the purchaser being considered as the equivalent of cash. (33—20—1134 O. D. 631.)

109 *Commissions on Sales of Property by Executor.*—An executor who pays to another, as agent, a commission upon the sale of property belonging to the estate may deduct from the selling price the amount so paid in determining the gain or loss arising from the sale.

An executor who retains as his commission a portion of the amount received by him from the sale of property belonging to the estate may not deduct the amount in preparing a return for the estate since any service performed by him in that connection is deemed to be a part of his duties as executor. Such a commission, however, should be included in the gross income reported in the executor's personal return for the year in which received.

Where property owned by an estate is sold, the amount of the stamp tax upon the deed conveying title to the property constitutes an allowable deduction in the return of the estate. (33—20—1135. O. D. 632.)

110 *Assessments and Repairs by Estates.*—Amounts expended by an estate on account of special assessments for the maintenance or repair of streets or for sidewalk improvements levied upon property used in a trade or business, if the same is necessary in the conduct of such trade or business, constitute allowable deductions.

In case any of the property of the estate is used for residential purposes by anyone beneficially interested in the estate, the amounts expended in payment of assessments levied upon such property for maintenance and repairs can not be deducted by the estate unless the rental value of the property is included in the gross income of the estate.

Amounts paid out for maintenance of streets and sidewalks used in connection with the business of the estate may be claimed as a deduction for the year in which such expenses were paid or accrued in accordance with the method upon which the taxpayer's books of account are kept.

Amounts expended for replacements can, under no circumstances, be claimed as a business expense. Such items are held to be investments of capital. If such replacements, however, are used in connection with the business of the estate, a reasonable amount may be claimed for exhaustion, wear and tear of the property, including obsolescence, in accordance with paragraph 8, section 214 (a) of the Revenue Act of 1918. (31—20—1102. O. D. 613.)

111 *Taxing income from real estate to the estate during administration.*—Where the deceased owner of real estate in the District of Columbia has not, in his will, directed the sale of real estate, or devised the same upon trust to be sold, to pay debts, legacies, or for other purposes, or done such other

act as to effect equitable conversion of his real estate at his death, and the personal property is sufficient to pay all the debts and legacies, the real property does not form part of the "estate" within the language of section 2 (b) of the Act of September 8, 1916, as amended, or of section 219 (a), (c), of the Revenue Act of 1918, and the executor of the estate will not be required to make a single return for the income from the real estate and the personal estate of the said decedent during the administration of the estate, even though the real estate was devised to a trustee. (13—20—811; S—1229A.)

112 *Facts Constituting an Association and Not a Trust.*—Where parties associating themselves for the purpose of purchasing and holding a parcel of real estate, title to which is vested in a trustee, reserve the right to direct and approve the terms of sale of the property deeded to the trustee, and the trustee is authorized to call upon them to pay certain items if the income of the trust is insufficient, the organization for income tax purposes is not a trust but an association which is required to render income and profits tax returns in accordance with provisions of the law governing corporations. (30—20—1083. O. D. 598—A.)

Disposal of Real Estate Through Sale, Exchange, etc.

201 *Sale of Capital Assets.*—Where property is acquired and later sold for a higher price, the gain on the sale is income. If, however, the property was acquired before March 1, 1913, only such portion of the gain as accrued subsequently to February 28, 1913, is taxable. Where, then, a corporation sells its capital assets in whole or in part, it shall include in its gross ncome for the year in which the sale was made the amount of the excess of the sales price over the fair market value of such assets as of March 1, 1913, if acquired prior to that date, or over their cost if acquired subsequently to that date. In every case, however, in ascertaining the gain, the cost of the assets, or the fair market value as of March 1, 1913, of the assets acquired prior thereto, should first be reduced by the amount of any charges for depreciation, depletion and other losses which have been or should have been made. If the purchaser takes over all the assets and assumes the liabilities, the amount so assumed is part of the purchase price. See also article 563. If the sale is made for stock of another corporation, the rules contained in section 202 of the statute and in articles 1561-1570 are particularly applicable. (Reg. 45, Art. 545, 1919.)

202 *Basis for Determining Gain or Loss from Sale.*—For the purpose of ascertaining the gain or loss from the sale or exchange of property the basis is (a) its fair market price or value as of March 1, 1913, if acquired prior thereto, or (b), if acquired on or after that date, its cost or its approved inventory value. In both cases proper adjustment must be made for any depreciation or depletion sustained. What the fair market price or value of property was on March 1, 1913, is a question of fact to be established by any evidence which will reasonably and adequately make it appear. As to inventories see section 203 of the statute and articles 1581-1585. The fair market value as of March 1, 1913, has no bearing on the determination of the invested capital of a corporation for the purpose of the war profits and excess profits tax. (Art. 1561, Reg. 45, Rev., April 17, 1919.)

203 *Sale of Property Acquired by Gift or Bequest.*—In the case of property acquired by gift, bequest, devise or descent the basis for computing gain or loss on a sale is the fair market price or value of the property at the date of acquisition or as of March 1, 1913, if acquired prior thereto. For the pur-

pose of determining the profit or loss from the sale of property acquired by bequest, devise or descent since February 28, 1913, its value as appraised for the purpose of the federal estate tax, or in the case of estates not subject to that tax its value as appraised in the State court for the purpose of State inheritance taxes, should be deemed to be its fair market value when acquired. See section 213 (b) (3) of the statute and article 73. (Art. 1562.)

204 *Exchange of Property.*—Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized. By way of illustration, if a man owning ten shares of listed stock exchanges his stock certificate for a voting trust certificate, no income is realized, because the conversion is merely in form; or if he exchanges his stock for stock in a small, closely held corporation, no income is realized if the new stock has no market value, although the conversion is more than formal; but if he exchanges his stock for a Liberty bond, income may be realized, because the conversion is into independent property having a market value. "Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. Property received in exchange for other property has no "fair market value" for the purpose of determining gain or loss resulting from such exchange when, owing to the condition of the market, there can be no reasonable expectation that the owner of the property, though wishing to sell and any person wishing to buy will agree upon a price at which to trade unless one or the other is under some peculiar compulsion. It does not follow that property has no "fair market value" merely because there is no price therefor established by public sales or sales in the way of ordinary business. The property received in exchange may be real estate, personal property, or a chose in action. Where the owner of a bond exercises the right, provided for in the bond, of converting the bond into stock in the obligor corporation, such transaction does not result in a realization of profit or loss, the transaction not being closed for purposes of income taxation until such stock is sold. (Reg. 45, Art. 1563, as amended by T. D. 2971, approved Feb. 4, 1920.)

205 *Determination of Gain or Loss from Exchange of Property* —(a) The amount of income derived in the case of an exchange of property, as of stock for a bond, is the excess of the fair market value at the time of exchange of the bond received

in exchange over the original cost of the stock exchanged for it, or over the fair market price or value of such stock as of March 1, 1913, if acquired before that date. The amount of income derived from a subsequent sale of the bond for cash is the excess of the amount so received over the fair market value of such bond when acquired in exchange for the stock. (b) On the other hand, if the property received in exchange is substantially the same property or has no market value, then no gain or loss is realized, but the new property is to be regarded as substituted for the old and upon a sale of the new property the amount of income derived is the excess of the amount so received over the cost or fair market value as of March 1, 1913, of the old. (Reg. 45, Art. 1564, 1919.).

206 *Exchange for Different Kinds of Property.*—(a) If property is exchanged for two different kinds of property, such as bonds and stock, the bonds having a market value and the stock none, the value of the bonds is to be compared with the cost or fair market value as of March 1, 1913, of the original property, as the case may be. If the market value of the bonds is less than such cost or value, the difference represents the cost of the stock. If the market value of the bonds is greater than such cost or value, the difference is taxable income at the time of the exchange and whenever sold the entire proceeds of the stock will be taxable. (b) If property is exchanged for two different kinds of property, such as bonds and stock, neither having a market value, the cost or fair market value as of March 1, 1913, of the original property should be apportioned, if possible, between the bonds and stock for the purpose of determining gain or loss on subsequent sales. If no fair apportionment is practicable, no profit on any subsequent sale of any part of the bonds or stock is realized until out of the proceeds of sales shall have been recovered the entire cost or fair market value as of March 1, 1913, of the original property. (Art. 1565, Reg. 45, Rev., April 17, 1919.)

207 *Compensation Paid in Notes*—Promissory notes received in payment for services, and not merely as security for such payment, constitute income to the amount of their fair market value. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, may properly treat as income as of the time of receipt the fair discounted value of the note at such time. Thus, if it appears that such a note is or could be discounted on a six or seven per cent basis, the recipient may include such note in his gross income to the amount of its face value less discount computed at the prevailing rate for such transactions. If the payments due on a note so accounted for are met as they become due, there should be included as income in respect of each such payment so much thereof as represents recovery for the discount originally deducted. (Art. 34, Reg. 45, Rev., April 17, 1919.)

208 *Gifts and Bequests.* The following rules should be followed by the Bureau of Internal Revenue in distinguishing a case of an actual gift and a case of a merely colorable gift:

(a) Where it appears that the owner of property has purported to transfer it without consideration to a member of his own family, or to any other person with whom he is in confidential relations, and that shortly thereafter a profitable sale of the security or property so transferred has occurred, such facts constitute *prima facie* evidence that the purported gift was not an actual gift and that the transfer was, in fact, merely colorable. In such case the so-called gift should be ignored in calculating tax, and the case should be investigated for evidence on which a charge of fraud could be supported in a contest.

(b) The prima facie case made out by the facts mentioned in the preceding paragraph may be rebutted by proof which establishes that it was not a transaction primarily for the advantage of the donor, and that there was no agreement or understanding, tacit or otherwise, that the donor was to receive back the proceeds or at any time control their disposition. Mere statements by the parties to the effect that the gift was genuine are regarded as of little weight; the best proof that a gift was a real gift would consist of facts showing that the position or relationship of the parties is such as to show a reasonable occasion for such a gift being made, and such as to explain the sale by the donee. Inquiry should be made as to the disposition of the proceeds.

(c) Where a taxpayer purports to make a gift to a member of his family or to a person in a confidential relation to himself, but no sale occurs, the question whether such gift was real or merely colorable is one to be decided on all of the facts. The mere fact that such conveyance is made may not lawfully be regarded as proof of fraud; but if the effect of the gift is to diminish tax liability, and it appears, either at the time of the gift or at any time thereafter, that the donor is deriving advantage from the property which he purported to give away, such facts constitute prima facie evidence that the gift was only colorable and the transaction should be treated as a nullity unless other facts are developed which show that it was a true gift. If such a gift is colorable only and made for the purpose of escaping tax, the donor is guilty of fraud and subject to penalty and punishment therefor. (7-19-290. S. 1022.)

209 *Sale of Real Estate Involving Deferred Payments.*—Deferred payments sales of real estate ordinarily fall into two classes when considered with respect to the terms of sale, as follows:

(1) Installment transactions, in which the initial payment is relatively small (generally less than one-fourth of the purchase price) and the deferred payments usually numerous and of small amount. They include (a) sales where there is immediate trans-

fer of title when a small initial payment is made, the seller being protected by a mortgage or other lien as to deferred payments, and (b) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the agreed installments have been paid.

(2) Deferred payment sales not on the installment plan, in which there is a substantial initial payment (ordinarily not less than one-fourth of the purchase price), deferred payments being secured by a mortgage or other lien. Such sales are distinguished from sales on the installment plan by the substantial character of the initial payment and also usually by a relatively small number of deferred payments.

In determining how these classes shall be treated in levying the income tax, the question in each case is whether the income to be reported for taxation shall be based only on amounts actually received in a taxing year, or on the entire consideration made up in part of agreements to pay in the future. (Art. 44.)

210 *Sale of Real Estate on Installment Plan.*—In the two kinds of transactions included in class (1) in the foregoing article, installment obligations assumed by the buyer are not ordinarily to be regarded as the equivalent of cash, and the vendor may report as his income from such transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price. If the return is made on this basis and the vendor repossesses the property after default by the buyer, retaining the previous payments, the entire amount of such payments, less the profit previously returned, will be income to the vendor and will be so returned for the year in which the property was repossessed, and the property repossessed must be included in the inventory at its original cost to himself (less any depreciation as defined in articles 161 and 162). If the taxpayer chooses as a matter of settled practice consistently followed to treat the obligations of the purchaser as equivalent to cash and to report the profit derived from the entire consideration, cash and deferred payments, as income for the year when the sale is made, this is permissible. If so treated the rule prescribed in article 46 will apply. (Art. 45.)

211 *Deferred Payment Sales of Real Estate Not on Installment Plan.*—In class (2) in the next to the last article the obligations assumed by the buyer are much better secured because of the margin afforded by the substantial first payment, and experience shows that the greater number of such sales are eventually carried out according to their terms. These obligations for deferred payments are therefore to be regarded as equivalent to cash, and the profit indicated by the entire consideration is taxable income for the year in which the initial payment was made and the obligations assumed. If the buyer de-

faults and the seller regains title to the land by agreement or process of law, retaining payments previously made, he may deduct from his gross income as a loss in the year of repossession any excess of the amount previously reported as income over the amount actually received, and must include such real estate in his inventory at its original cost to himself (less any depreciation as defined in articles 161 and 162). (Art. 46.)

212 *Sale of Real Estate in Lots.*—Where a tract of land is purchased with a view to dividing it into lots or parcels of ground to be sold as such, the entire fair market value as of March 1, 1913, or the cost, if acquired subsequently to that date, shall be equitably apportioned to the several lots or parcels and made a matter of record in the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels may be returned as income for the year in which the sale was made. This rule contemplates that there will be a measure of gain or loss in every lot or parcel sold, and not that the capital invested in the entire tract shall be extinguished before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction and the gain or loss will be accounted for accordingly. (Art. 43.)

213 *Deposit Upon Contract Does Not Fix Time of Sale.*—Pursuant to a contract to sell real estate, executed in 1917, at which time a small cash consideration was paid, delivery of the deed and transfer of possession took place in 1918, in which year a substantial payment was made and notes secured by mortgage for the unpaid balance were given.

Held that vendor should report the profit realized from the transaction as gross income for 1918, and that the small advance payment made in 1917 should be treated as a return of capital, since it was less than the cost of the property to the vendor and did not, therefore, constitute taxable income for 1917. (2-20-671. A. R. R. 13.)

214 *No Gain or Loss Upon Contract to Sell.*—No realization of gain or loss arises from a mere contract to sell real estate in the future. The sale is held to occur at the time a deed passes or at the time possession and the burdens and benefits of ownership are from a practical standpoint transferred to the buyer, whichever occurs first. Payments made prior to the sale are to be applied in reduction of cost so far as they do not exceed cost; being treated as income to the extent, if any, to which cost is exceeded. (8—20—751. O. 988.)

215 *Installment Sales do not Apply Only to Dealers.*—For the purpose of the income tax, sales of real or personal property on the installment or deferred payment plan, as described in articles 42 to 46 of Regulations 45, shall be treated as therein provided, regardless of whether the sale is made by a dealer or other individual. (18—20—894. O. D. 482.)

216 *Sale of Real Estate in Lots, Where Development Work to be Completed After Sale.*—Where building lots contained in a given tract of land are sold before the contemplated development work is completed the profit realized should be determined on the basis of the cost of the land, or its fair market value on March 1, 1913, if acquired prior to that date, plus acutal and estimated future expenditures for the development of the property in accordance with the contract of sale. (12—19—399. O. D. 226.)

217 *Sale of Real Estate Involving Deferred Payments Where Notes Given.*—In the case of real estate sales involving deferred payments, even though substantial first payment is made, if the notes given by buyers of real estate can not be discountd nor sold on account of lack of credit of the buyers, such notes need not be regarded as the equivalent of cash, and the vendors may report as their income from the proposed transaction for each year only the proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price. (8—19—314. O. D. 181.)

218 *Deferred Payment Sales of Real Estate not on the Installment Plan, Assumption of Mortgage.*—A sold to B real estate which was mortgaged to secure a loan made by a State. B agreed to make payment, partly in cash, assume payment of the mortgage held by the State, and give A a mortgage to cover the balance of the sale price. Notwithstanding that the State will not accept B's promise to pay in lieu of A's original note and mortgage, thus leaving A liable for payment of the note in case B defaults, it is held that A has received the full amount of the sale price in cash or its equivalent and should report the entire profit realized as income for the year in which the sale was consummated. (11—20—734. O. D. 409.)

219 *Facts Showing Cash Sale and not Installment Sale.*—A tract of land was sold on November 1, 1919, for 10x dollars, of which amount x dollars accompanied the bid, 4x dollars was paid in December, 1919, and the balance in January, 1920, at which time a proper conveyance of title was delivered to the purchaser. This sale is to be treated as a cash transaction for 1919, and the entire profit realized must be returned as taxable income for that year. (27-20-1037. O. D. 568.)

220 *Basis for Determining Gain or Loss from Sale of Land With Growing Crops.*—A purchased for a certain price land together with crops growing thereon. The basis for determining gain or loss upon a subsequent sale of the crops is the difference between the cost, or if no part of the purchase price was assigned to the crops, the fair market value thereof at the time of purchase, and the selling price less cost of harvesting and marketing. (42—20—1285. O. D. 714.)

221 *Facts Constituting Cash and not Installment Sale.*—An individual who sold a parcel of real estate in 1918 for $60x$ dollars received a payment of $5x$ dollars on March 1, 1918, the date on which the sale was consummated, a payment of $2\frac{1}{2}x$ dollars on July 1, 1918, and a payment of $10x$ dollars on December 1, 1918, or a total of $17\frac{1}{2}x$ dollars during the year 1918. It was provided that the balance of the selling price would be paid in installments falling due on December 1 of each year thereafter, including the year 1922, such deferred payment being secured by crop mortgages and additional collateral security.

Held, the vendor should have included the entire profit realized on the sale in his return for 1918. (27-20-1038. O. D. 569.)

222 A loss sustained from the sale of property acquired by gift, bequest, devise, or descent (whenever property so acquired is as a matter of fact acquired for purposes of profit) is a deductible loss from gross income. Ordinary investment property so acquired is to be treated as having been acquired for purposes of profit unless the conduct of the recipient furnishes evidences to the contrary. (10-19-357. T. B. R. 35.)

223 *Development Work, Actual or Estimated.*—Profit realized on the sale of lots, the selling price of which includes the cost of certain development work already made or to be made in accordance with the contract of sale, should be based on the cost of the land to the vendor, or its fair market value as of March 1, 1913, if acquired prior to that date, plus the actual and estimated future expenditures for development. If the estimated future expenditures should be subsequently ascertained to be incorrect, amended returns should be filed as the basis for an adjustment of the tax for the years affected. The cost of such development having been taken into consideration in determining profit, expenditures for this purpose can not be deducted from gross income in subsequent returns. (27—20—1036. O. D. 567.)

224 *Property Condemned by City.*—Certain property owned by an estate was in 1906 listed by a city to be condemned for public purposes. The property was not destroyed until 1917. During that year a verdict was rendered awarding the estate x dollars, with interest at the rate of 6 per cent. per annum from 1906, the date the property was listed for condemnation. Mandamus proceedings were instituted to enforce the settlement of this award, and in 1920 the estate received payment of the face value of the claim, together with interest accrued since 1906, and costs.

Held, that the measure of taxable income is the excess of the sum of the principal and accrued interest actually received over the fair market value of the claim representing such principal and interest accrued as at March 1, 1913. Such excess as regards

the principal of the claim is taxable as of the year 1920, in which it was received. The amount of the interest received is exempt from income tax as interest on the obligation of a political subdivision of a State within the meaning of section 213 (b) 4 of the Revenue Act of 1918.

The cost of mandamus proceedings was a replacement of the amount expended by the estate in the collection of a debt and should not be included in gross income of the estate. Nor should it be taken as a deduction in computing net income for the year in which expended. (20—20—1071. O. D. 591.)

225 *Contract in One Year, Sale in Another.*—A sells his farm to B in August, 1919, for $10,000, receiving a cash payment of $2,500, balance to be paid March 1, 1920, when deed is to be delivered. Is any part of the tax on profits in this deal to be included in A's return for 1919? Or is it all to be included in his return for 1920?

The profit on the entire transaction should be reported by A as income for 1920. If the contract is cancelled and the $2,500 is forfeited that amount is taxable income to A. (F. B. Q40.)

226 A contract to sell a farm was made in 1919, payment of $1,000 down, balance to be paid in 1920, upon possession and delivery of deed. What part of cash payment goes in 1919 return?

None. Profit on the sale should be returned as income for 1920. However, if the sale is not completed and the $1,000 is forfeited, the seller should return that as income. (F. B. Q37.)

227 *Contract for Sale, When Consummated.*—A man in 1919 entered into a contract for the sale of his farm, the contract price being $40,000. His profit was $10,000. He received $800 down on contract, and was to receive $10,000 on March 1, 1920, $10,000 on March 1, 1921, and $9,200 on March 1, 1922, the deferred payments being secured by a mortgage on the land; deed and possession were to be given on March 1, 1920. How should the profit be returned for income-tax purposes?

This transaction is a contract for sale in the future as distinguished from a present sale, as only a small cash payment was made and the deed and possession were not to be delivered until March 1, 1920. The $800 is held to be a return of capital, no part of which is taxable income for 1919. Inasmuch as the sale will be consummated on March 1, 1920, the entire profit from the transaction should be reported as income for the year 1920. Taxable income will be received to the extent that the contract price of $40,000 plus the amount of any depreciation sustained on the buildings upon the land (exclusive of the tax-payer's residence), since March 1, 1913, exceeds the cost of the farm (or its fair market value as of March 1, 1913, if it was acquired prior to that date), plus the cost of any permanent improvements made

by the seller since March 1, 1913, and not claimed by him in any return of income. (F. B. Q35.)

228 *Contract for Sale Cancelled.*—Please advise what report should be made on a farm sale made by contract in 1919 on which $1,000 was paid and the balance of purchase money to be paid March 1, 1920; after January 1, 1920, a mutual agreement was entered into whereby the contract was canceled by the return of the $1,000 and a further consideration of $1,000 paid by the seller for the cancellation of the contract. Would this be considered a purchase of the farm, or would it be considered a loss of $1,000 paid for cancellation of the contract in the 1920 income?

(a) Assuming that the original payment of $1,000 was made by the purchaser merely as a pledge for good faith in performance of the contract, the transaction is considered incomplete and as not affecting income during 1919.

(b) The $1,000 which the seller paid in 1920 to be relieved from the terms of the original contract is a capital investment and should be treated as additional cost of the farm. (F. B., Q34.)

229 *Deposit on Contract for Sale.*—A sells a farm on contract in 1919 for $25,000, deed and possession to be given March 1, 1920; $2,000 is received by A during 1919 on this contract as first payment; is this $2,000 income for 1919 or 1920?

The contract is executory during 1919, hence no part of the $2,000 is taxable in A's hands for that year if it does not exceed the cost or fair market value as of March 1, 1913, if acquired prior thereto. If the contract is canceled and the $2,000 is forfeited, that amount is taxable income to the seller. That portion of the $2,000 representing a profit on the transaction should be reported (with the balance of the profit realized) by A as taxable income for the year 1920. (F. B. Q47.)

230 *Market Value March* 1, 1913, *How Determined.*—How is the value as of March 1, 1913, of property sold in 1919, to be determined?

No method of determining this value can be stated which will adequately meet all circumstances. What that value was is a question of fact to be established by any evidence which will reasonably or adequately make it appear. (F. B. Q33.)

231 *Property Acquired on or after March* 1, 1913 *Gain or Loss on Sale Thereof.*—How am I to determine the amount of gain or profit derived from sale of property which is returnable for income-tax purposes?

If you acquired the property sold prior to March 1, 1913, you should take its fair market price or value of that date, add thereto all amounts subsequently expended in making improvements, deduct therefrom depreciation sustained between March 1, 1913,

and date of sale, and the difference between the result obtaind and the selling price is the amount to be reported under gross income.

If you purchased the property on or after March 1, 1913, the difference between its cost plus all amounts subsequently expended for permanent improvements less depreciation sustained for years to 1919 and its selling price is to be returned.

If the property came to you on or after March 1, 1913, as an inheritance the difference between the appraisal value placed upon it at the date of the death of the testator plus all amounts subsequently expended for permanent improvements less depreciation as above indicated and its selling price is to be returned. (F. P. Q32.)

232 *Depreciation Not to be Considered on Sale of Residence.*—Inasmuch as no deduction for depreciation of the personal residence of a taxpayer is allowable in his income tax returns, a taxpayer in determining the gain arising from the sale of his personal residence, continuously occupied by him as such, is not required to reduce the cost of the property or its fair market value as at March 1, 1913, by the depreciation sustained. (O. D. 600.)

233 *Contract for Sale Cancelled.*—On August 1st, 1919, A sells his farm to B on contract, complete payment to be made, deed and possession to be delivered on March 1, 1920. On December 1, 1919, A buys his own farm back giving B a profit of $5,000 and destroys the original contract. No deed is ever executed. Is A liable to an income tax on the profit he had made in the original deal? If not, then is the $5,000 he paid to get the contract released less than can be deducted in computing his income for the year?

A made no profit on the original transaction. The contract was clearly executory at that time, since its completion was contingent upon the conveyance of title and deliverance of property on March 1, 1920. The $5,000 payment by A, over and above the consideration named in the first contract, was, in fact, an amount paid by A to be relieved from the terms of the contract, and is additional cost of the property and should be treated as a capital investment. (F. B. Q39.)

234 *Transfer not Recorded.*—A, in 1893, purchased land for a summer residence and deeded the entire tract to his wife. Shortly thereafter a part of the land was sold to B for the erection of a hotel. B defaulted and A bought the property in at a foreclosure sale (presumably before March 1, 1913), placing the title again in his wife's name. The income from the property was included in the wife's returns for 1913 to 1917, inclusive. During 1917 the property was transferred to A, but the deed was never recorded, and there are circumstances which indicate that the parties did not consider it as a valid and

binding transfer. For 1918 the income from the property was reported by A. In 1919 the property was sold, A's wife giving the deed.

Held, that A's wife was at all times during the period from March 1, 1913, to the date of sale, the owner of the property, and that she should have reported the income for every year during such period. Held also, that any loss sustained upon the sale in 1919 is to be claimed in her return; not in the return of A. (24—26—999. O. D. 543.)

235 *Sale by Partnership to Partner.*—A and B are operating a farm in partnership and for that purpose sell the personal property at public sale. A buys the most of the property, in which he already owns a half interest. Must an income tax be paid by the partnership on the total amount of the sale in view of the fact that A already owned a half interest in the property?

For the purpose of ascertaining the gain or loss from the sale of property the partnership should report the difference between the cost of the property or its fair market value as of March 1, 1913, if acquired prior thereto, and the sale price. The fact that one of the partners purchased the property from the partnership would not affect the profit or loss to be reported by the partnership on Form 1065. Under the Revenue Act of 1918 partnerships as such are not subject to income or profits tax. (F. B. Q41.)

236 *Compensation for Property Requisitioned.*—Articles 49 and 50, Regulations 45, provide that in cases where an owner of property has lost or transferred title to it by reason of the exercise of the power of requisition or eminent domain, and proceeds immediately in good faith to replace the property, or where it is not practicable to immediately replace same and application is made to establish a replacement fund, the gain which is to be included in gross income is measured by the excess of the amount received as compensation or reimbursement over the amount actually and reasonably expended to replace the property substantially in kind.

The provisions of these two articles are applicable to property used for residential or farming purposes. (21—20—949. O. D. 513.)

237 *When Included in Gross Income.*—Gains, profits and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included when they accrue to him in accordance with the approved method of accounting followed by him. See articles 21-24. Lands which are received as compensation for services in one year, the title to which is disputed and in a later year adjudged to be valid, constitute income to the grantee in the former year. On the other hand, a person may sue in one year on a

pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. This is true of a recovery for patent infringement. Bad debts or accounts charged off because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. See articles 111 and 151. In view of the unusual conditions prevailing at the close of the year 1918 it is recognized that many items of gross income, such as claims for compensation under cancelled contracts, together with claims against contracting departments of the Government for amortization and other matters, while property constituting gross income for the taxable year 1918 were undecided and not sufficiently definite in amount to be reported in the original return for that year. In every such case the taxpayer should attach to his return a full statement of such pending claims and other matters, and when the correct amount of such items is ascertained an amended return for the taxable year 1918 should be filed. (Art. 52.)

238 *Exchange of Property and Stock.*—Where property is transferred to a corporation in exchange for its stock, the exchange constitutes a closed transaction and the former owner of the property realizes a gain or loss if the stock has a market value, and such market value is greater or less than the cost or the fair market value as of March 1, 1913 (if acquired prior thereto), of the property given in exchange. For the rule applicable where a corporation, in connection with a reorganization, merger or consolidation, exchanges property for stock, see article 1567. (Reg. 45, Art. 1566, as amended by T. D. 2924, September 26, 1919.)

239 *Exchange One Piece of Land for Another.*—In 1914, A bought 160 acres of land at $175 an acre. Recently B bought 160 acres for $375 an acre with the idea of putting the same on the market at once. There are no buildings on either parcel of land. B finds upon investigation that if he had A's 160 acres of land he could sell the same. Accordingly he takes up the matter with A. It so happens that the land owned by B is in a territory where A had formerly lived and for that reason he accepts the proposition of B's "trading even up." In the contract which is made by A and B it is specified that they are trading the land on a basis of $425 an acre, which is assumed to be its actual market value. In the whole transaction A does not receive a cent in cash and in fact will be at some expense because of having to move. Should A have to pay an income tax on this transaction?

Yes. The difference between the cost to A of the land originally held by him ($175 per acre) and the value of the land re-

ceived in exchange ($425 per acre) represents profit to A and is subject to income tax.

The difference between the cost to B of the land originally held by him ($375 per acre) and the value of the land received in exchange ($425 per acre) represents profit to B and is subject to income tax. (F. B.—Q38.)

240 *Exchange of Farms.*—Two neighbors own farms and wish to exchange, without any money consideration except the land traded, it simply being a matter of location suiting each party better. Would this be considered a sale by each party, subject to profits based on 1913 values?

Yes. Such transaction is considered a sale by each party and the basis for computing the profit on each sale is the cost of the farm or the fair market value as of March 1, 1913, if acquired prior thereto. Proper adjustment should be made for any depreciation sustained on buildings which are on the farms, and the cost of any improvements. (F. B., Q42.)

241 *Exchange of Farms.*—A and B each owned an 80-acre farm. A wanted to buy a 67-acre farm which was adjoining the 80 acres owned by B so they traded one 80 for the other 80 and neither party received any cash consideration, having made an even trade. Should this trade be included in the returns of either A or B, and if so, how should it be computed?

In the exchange of properties having the same market value, gain or loss is realized by each owner to the amount of the difference between the fair market value at the time of the exchange of the property received and the cost or fair market value as of March 1, 1913, if acquired prior thereto, of the property exchanged plus the cost of any permanent improvements and less any depreciation sustained. (F. B., Q43.)

242 *Exchange of Farm for Farm Plus Cash.*—A exchanges farms with B as follows: A gives farm as first payment of $40,000, same having been acquired after March 1, 1913, for $20,000. Possession given on contract to run for five years at which time the balance due which is $60,000, is paid and deed given. When and how should return be made?

A has made a profit of $20,000.

B is held to have received cash and property equal to the value of $100,000 in exchange for his farm and he is required to return as taxable profit for the year in which the exchange was made the excess of the amount received for his farm, over the fair market value of the farm as of March 1, 1913, if acquired prior thereto, or its cost if acquired on or after that date. Proper adjustment must be made for depreciation sustained and also for the cost of any improvements. (F. B., Q44.)

243 *Exchange of Farm for City Land Plus Cash.*—A farmer sells his farm for $15,000, received $10,000 cash and a city property, which will not sell for more than $3,000, that amount being the most offered for it. The fair market value of the farm on March 1, 1913, was $15,000, and he acquired it prior to that date. How will he treat this transaction in his report, as a sale for $13,000, or a sale for $15,000?

This is in effect a modification of the original contract of sale, by which seller agrees to accept a consideration of $13,000, instead of the stipulated price of $15,000. The farmer therefore suffers a loss of $2,000. (F. B., Q45.)

244 *Exchange of Farms Same as Sale.*—Under the provisions of section 202 of the statute, and in accordance with article 1563 of Regulations 45, the exchange of farm lands in all cases in which the farm land exchanged has a market value constitutes a completed or closed transaction from which a gain or loss is realized, even though the land received in exchange may be of a similar kind and of similar value. (14—20—821. O. D. 429.)

245 *Fair Market Value Defined.*—The "fair market value" of property is the fair value of the property in money as between one who wishes to purchase and one who wishes to sell, and is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price, and recognizes that property has no "fair market value" when market conditions are such that there would be no trading in the property in question at a fair price. (19—19—494. T. B. R. 57.)

246 *Surplus and Undivided Profits: Property Taken for Debt or in Exchange.*—Real or personal property taken by a corporation in payment or satisfaction of a debt, or property received in exchange for other property, will be an admissible asset at its fair market value upon receipt. The profit or loss, if any, resulting from the transaction will not be reflected in invested capital until the succeeding taxable year. But see as to the foreclosure of a mortgage article 153. See also section 202 of the statute and articles 1561-1570. (Reg. 45, Art. 847, 1919.)

247 *Dividends Paid in Property.*—Dividends paid in securities or other property (other than its own stock), in which the earnings of a corporation have been invested, are income to the recipients to the amount of the fair market value of such property when receivable by the stockholders. A dividend paid in stock of another corporation is not a stock dividend. Where a corporation declares a dividend payable in stock of another corporation, setting aside the stock to be so distributed and noti-

tying the stockholders of its action, the income arising to the recipients of such stock is its fair market value at the time the dividend becomes payable. See article 53. Scrip dividends are subject to tax in the year in which the warrants are issued. (Art. 1544, Reg. 45, Rev., April 17, 1919.)

Leased Property

301 *Rents and Royalties.*—When buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor receives income at the time when such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease, without such improvements and the value of the land subject to the lease with such improvements. If, for any other reason than a bona fide purchase from the lessee by the lessor, the lease is terminated, so that the lessor comes into possession and control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the fair market price or value thereof to him as determined when the same completed became part of the realty. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the termination of the lease the lessor is entitled to deduct as a loss of the year when such destruction takes place the fair market price or value of such buildings or improvements subject to the lease as determined when the same completed became a part of the realty, or the value thereof subject to the lease on March 1st, 1919, less any salvage value subject to the lease, to the extent that such loss was not compensated by insurance. (Reg. 45, Art. 48, as amended by T. D. 3062, approved September 1, 1920.)

302 *Rentals.*—Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment to such taxpayer his investment of capital, an annual deduction

and not deductible as a business expense. In order to return may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvements made, this deduction shall take the form of an allowance for depreciation. See article 48. (Reg. 45, 109, as amended by T. D. 3062, approved September 1, 1920.)

303 *Income from Leased Property.*—Where a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance or other fixed charges, such payments shall be considered rental payments and shall be returned by the lessor corporations as income, notwithstanding the fact that the dividends and interests are paid by the lessee directly to the stockholders and bondholders of the lessor. The fact that a corporation has conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or stockholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the stockholders such amounts are interest and dividend payments received as from the lessor, and as such shall be accounted for in their returns. (Reg. 45, Art. 546 1919.)

304 *Agreement by Lessee to Make Improvements or Restore to Original Condition.*—A corporation leased a building for a period of 10 years, and as lessee agreed to make any desired improvements or alterations at its own expense. Upon termination of the lease the premises will revert to the lessor together with all improvements and alterations so made or at the option of the lessor the lessee may be required to remove same at its own expense and restore the premises to their orginal condition.

Held, that the lessee may pro rate the cost of the alterations and improvements over the life of the lease and claim a suitable deduction each year, but that it may not set up a reserve to cover the cost of restoring the premises to their original condition. The expense of restoring the property at the expiration of the lease, if the lessee is required to restore it, will be an allowable deduction for the year in which it is actually incurred. (21—20—952. O. D. 516.)

305 *Subletting of Apartment.*—The subletting of an apartment by a tenant on account of being required to make his residence in another city, is held not to be a "transaction entered into for profit." Therefore, any loss sustained through such transaction is not deductible from gross income. (1—19—59. O. D. 42.)

306 *Basis for Determining Gain or Loss from Sale of Lease.*—By the terms of a lease for five years effective January 1, 1918, A, as lessee, was authorized to make repairs or improvements to the leased premises at his own expense, such improvements to revert to the lessor upon expiration of the lease. Certain improvements were made by A, and shortly thereafter in June, 1919, he assigned the lease at a profit. Inquiry is made as to the amount of taxable income derived by him from the transaction.

The cost of making the improvements to the leased property by A was a capital investment. Such capital investment was, so long as he remained the lessee, returnable to him free from tax prorated over the life of the property, if less than the life of the lease, otherwise over the life of the lease. A, having terminated the lease so far as he was concerned in June, 1919, was, in computing his taxable profit from the transaction in accordance with section 202 of the Revenue Act of 1918, entitled to deduct from the sale price of the lease the cost of the improvements, less so much of such cost as had already been returned to him free from tax through deductions previously claimed as outlined above. (50—20—1339. O. D. 746.)

Depreciation and Obsolescence

401 *Depreciable Property.*—The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art or to becoming inadequate to the growing needs of the business. It does not apply to inventories or to stock in trade; nor to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provision for this being made in the statute. See articles 201-233. Property kept in repair may, nevertheless, be the subject of a depreciation allowance. See article 103. The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business. No such allowance may be made in respect of automobiles or other vehicles used chiefly for pleasure, a building used by the taxpayer solely as his residence, nor in respect of furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance. (Art. 162.)

402 *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as covering depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear or tear or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost, or its value as of March 1, 1913, if acquired by the taxpayer before that date. (Reg. 45, Art. 161, 1919.)

403 *Charging Off Depreciation.*—A depreciation allowance, in order to constitute an allowable deduction from gross income, must be charged off. The particular manner in which it

shall be charged off is not material, except that the amount measuring a reasonable allowance for depreciation must be either deducted directly from the book value of the assets or preferably credited to a depreciation reserve account, which must be reflected in the annual balance sheet. The allowances should be computed and charged off with express reference to specific items, units or groups of property, each item or unit being considered separately or specifically included in a group with others to which the same factors apply. The taxpayer should keep such records as to each item or unit of depreciable property as will permit the ready verification of the factors used in computing the allowance for each year for each item, unit or group. (Art. 169.)

404 *Method of Computing Depreciation Allowance.*—The capital sum to be replaced should be charged off over the useful life of the property either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and should be described in the return. (Reg. 45, Art. 165, 1919.)

405 *Modification of Method of Computing Depreciation.*—If it develops that the useful life of the property has been underestimated, the plan of computing depreciation should be modified and the balance of the cost of the property, or its fair market value as of March 1, 1913, not already provided for through a depreciation reserve or deducted from book value, should be spread over the estimated remaining life of the property. Inasmuch as under the provisions of the income tax Acts in effect prior to Revenue Act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was sold or permanently abandoned, a taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art. No modification of the method should be made on account of changes in the market. (Reg. 45, Art. 166, as amended by T. D. 3061, approved August 27, 1920.)

406 *Capital Sum Recoverable Through Depreciation Allowances.*—The capital sum to be replaced by depreciation allowances is the cost of the property in respect of which the allowance is made, except that in the case of property acquired by the taxpayer prior to March 1, 1913, the capital sum to be replaced is the fair market value of the property as of that date. In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property less depreciation up to that date. To this sum should

be added from time to time the cost of improvements, additions and betterments, the cost of which is not deducted as an expense in the taxpayer's return, and from it should be deducted from time to time the amount of any definite loss or damage, sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility which is the basis of the depreciation allowance. In the case of the acquisition after March 1, 1913, of a combination of depreciable and non-depreciable property for a lump price, as, for example, land and buildings, the capital sum to be replaced is limited to that part of the lump price which represents the value of the depreciable property at the time of such acquisition. Where the lessee of real property erects buildings, or makes permanent improvements which become part of the realty and income or loss has been returned by the lessor as a result thereof, as provided in Article 48, the capital sum to be replaced by depreciation allowances is held to be the same as though no such buildings had been erected, or such improvements made. (Reg. 45, Art. 164, as amended by T. D. 3062, approved September 1, 1920.)

407 *Closing Depreciation Account.*—If the use of any property in the business is permanently discontinued, although no sale or other disposition of the property has taken place, a determination of any gain or loss may be made; but any deduction in respect of any loss thereon must be disclosed in the taxpayer's return for the year in which the determination is made and a full statement of the facts and the basis upon which the computation is calculated must be attached to the return. Upon a sale or other disposition of the property, the consideration received shall be compared with the amount of the estimated salvage value used in computing the gain or loss as above provided, and the amount of the difference shall be treated as a gain or loss, as the case may be, of the year in which the sale or other disposition was made. (Reg. 45, Art. 170, 1919.)

408 *Obsolescence of Buildings.*—Prior to the passage of the Revenue Act of 1918, no deduction on account of obsolescence was permitted. It is true that articles 177, 178 and 179 of Regulations No. 33, revised, promulgated in connection with the Revenue Act of 1917, authorize deductions for obsolescence, but the term as there used refers not to the gradual reduction in value due to the normal progress of the art but rather to the amount of loss sustained when the property has become obsolete. It contemplates a completed rather than a continuing process. Its parallel is to be found in article 143 of Regulations 45—Loss of Useful Value.

No amount may be charged off in any year in anticipation of obsolescence of a building which may become obsolete a num-

ber of years later. A certain amount of obsolescence may, however, be claimed from the time it becomes certain that at a definite future date the building will be obsolete. The figure representing obsolescence shall be approximately the difference between the fair market value of the building as at March 1, 1913, or its cost if acquired on or after that date, less depreciation, and the estimated salvage value. This obsolescence should be spread over the period from the time such obsolescence becomes certain until the building becomes obsolete, and should be claimed in the returns filed for those years. For instance the fair market value of a building March 1, 1913, was $30,000. Its depreciated value December 31, 1918, was $18,000 and its estimated salvage value in 1920 will be $5,000. At the end of the year 1918, it was definitely determined and certain that in 1920 the building would have to be torn down and replaced by a larger building, due to its inadequacy to meet the growing demands of the industry which it housed. The difference between the depreciated value December 31, 1918 ($18,000), and its estimated salvage value ($5,000) represents ordinary depreciation plus obsolescence. This amount of $13,000 should be spread over the years 1919 and 1920, and deduction claimed accordingly in returns filed for those years. In cases where obsolescence is claimed, it must be supported by a statement sufficient to establish the facts upon which it is based. F.

409 *Depreciation of Buildings.*—Buildings are recognized as subject to depreciation and in some cases to obsolescence regardless of their construction or purpose for which used. The deduction is allowable, however, only in the case of buildings owned by the taxpayer and used in trade or business. The rate of depreciation will necessarily depend upon the construction of the building, purpose for which used, climatic conditions, repairs made, etc. A frame building may remain serviceable for a period of 20 to 30 years, while a building of steel, concrete and stone construction may have a life of 50 to 100 years. The ordinary useful life of factory buildings is further lessened by the vibration incident to the use of heavy high-speed machinery, or by the effect of acids or gases used in certain industries. Similarly constructed buildings will depreciate at varying rates, dependent upon local climatic conditions. The rate to be used in computing the allowance for depreciation will depend in each case upon the conditions affecting the particular property in question. F.

410 *Depreciation of Personal Residence.*—Depreciation of a building occupied by a taxpayer as his personal residence is not deductible for income tax purposes. If a portion of the residence is used for business purposes, as in the case of a physician or any other professional man who has his office in his home, a proportionate part of the depreciation sustained may be de-

ducted, the amount to be based generally on the ratio of the number of rooms used for business purposes to the total number of rooms in the building. The same principle is applicable if a taxpayer rents a portion of his personal residence to other individuals. Under such conditions, however, the taxpayer must include in his gross income any amounts received as rentals. A taxpayer who is not allowed a deduction for depreciation of his personal residence may, in case he sells the property, disregarded depreciation in computing any taxable profit derived from the transaction.

If a taxpayer owns residential property and rents it to other individuals, he is entitled to a deduction for depreciation of the rented property even though the property is not used in his principal trade or business but must include in gross income the entire amount received as rentals. F.

411 *Alteration of Building.*—Expenditures by a taxpayer in altering a building to conform to a street widening, which alteration does not increase the value of the building, constitute a business expense for the year in which such expenditures are incurred, deductible only in the return of net income for that year, and any division of such deduction so as to spread the same over the returns for a period of years, whether called a depreciation charge or otherwise, is unauthorized. F.

412 *Lessor and Lessee.*—Ordinarily an allowance for depreciation may be taken only on account of property owned by the taxpayer and used in trade or business and may not be taken on account of property of which he is merely the lessee. This will not preclude the deduction each year by the lessee of an aliquot part of the cost or the bonus paid for the lease. In the case of additions, improvements, or betterments to the property made at the expense of the lessee, which, according to the terms of the lease, revert to the lessor at the termination of the lease, the lessee may apportion the cost of such additions, etc., over the life of the lease and deduct an aliquot part thereof each year. If, however, the life of improvements for business purposes made at the expense of a lease is less than the life of the lease, depreciation may be taken by the lessee instead of treating the cost as additional rent. Stockholders of a corporation are not entitled to deduct in their individual returns any amount on account of depreciation on the property of the corporation from which they receive dividends. F.

413 *Anticipated Obsolescence.*—No amount may be charged off in any year in anticipation of obsolescence of a building which may become obsolete 5 or 10 years later. However, a certain amount of obsolescence may be claimed from the time that it becomes certain that at a definite future date the building will be obsolete. The figure representing obsolescence should be approxi-

mately the diferenc between the fair market value of the building as of March 1, 1913, or its cost if acquired after that date, less depreciation, and the estimated salvage value. This obsolescence should be spread over the period from the time such obsolescence becomes certain until the building bcomes obsolete and should be claimed in the returns filed for those years. For instance, the fair market value of a building March 1, 1913, was $30,000. Its depreciated value December 31, 1918, was represented by $18,000, and its estimated salvage value will be $5,000 in 1920. At that time (Dec. 31, 1918) it was definitely determined and certain that in 1920 the building would have to be torn down and rebuilt, due to its inadequacy to meet the growing needs of the industry it housed. The difference between the depreciated value December 31, 1918, namely, $18,000, and its estimated salvage value of $5,000 represents obsolescence. This amount of $13,000 should be spread over the years covering the period 1919 and 1920 and deductions claimed accordingly on the returns filed for those years. In cases where obsolescence is claimed it must be supported by facts which will enable this office to determine whether such claim is proper and allowable. (4—20—704. O. D. 381.)

414 *Obsolescence of Brewery.*—Property consisting of a plant, including equipment for the manufacture of beer bottles, which because of restrictions and regulations by the United States Government on the brewery industry can not be sold and in consequence the factory had to be closed, had to the extent the property or plant was constructed for the manufacture of beer bottles and is not suited or adapted for any other purpose without reconstruction, become obsolete. The corporation to that extent is entitled to a deduction for obsolescence. So much of the shrinkage in value of the plant, if any, as is not thus due to obsolescence can not be claimed as a deduction for loss until the property is sold or becomes worthless and the loss is definitely ascertained. (3—19—190. O. D 125.)

415 *Loss of Useful Value.*—When through some change in business conditions the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in the business, he may claim as a loss for the year in which he takes such action the difference between the cost or the fair market value as of March 1, 1913, of any asset so discarded (less any depreciation allowances) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property must be prematurely discarded, as, for example, where machinery or other property must be replaced by a new invention, or where an increase in the cost

of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off on the books and fully explained in returns of income. (Art. 143.)

416 *Loss on Sale of Residence.*—A loss sustained by an individual from the sale of residential property is deductible in determining net income for purposes of the Revenue Act of 1918 only when the property was purchased or constructed by him with a view to its subsequent sale for pecuniary profit. The intent in purchasing on constructing the property is a question of fact determinable in each case by evidence which should be submitted with the return. (1—19—51. O. 780.)

417 *Voluntary Removal of Buildings.*—Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery equipment, etc., incident to renewals and replacements may be deducted from gross income in a sum representing the difference between the cost of such property demolished or scrapped and the amount of a reasonable allowance for the depreciation which the property had undergone prior to its demolition or scrapping; that is to say, the deductible loss is only so much of the original cost of the property, less salvage, as would have remained unextinguished had a reasonable allowance been charged off for depreciation during each year prior to its destruction. F.

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501 *Compensation for Loss.*—In the case of property which has been lost or destroyed in whole or in part through fire, storm, shipwreck or other casualty, or where the owner of property has lost or transferred title by reason of the exercise of the power of requisition or eminent domain, including cases where a voluntary transfer or conveyance is induced by reason of the fact that a technical requisition or condemnation proceeding is imminent, the amount received by the owner as compensation for the property may show an excess over the value of the property on March 1, 1913, or over its cost, if it was acquired after that date (after making proper provision in either case for depreciation to the date of the loss, damage or transfer.) The transaction is not regarded as completed at this stage, however, if the taxpayer proceeds immediately in good faith to replace the property, or if he makes application to establish a replacement fund as provided in the following article. In such a case the gain, if any, is measured by the excess of the amount received over the amount actually and reasonably expended to replace or restore the property substantially in kind, exclusive of any expenditures for additions or betterments. The new or restored property effects a replacement in kind only to the extent that it serves the same purpose as the property which it replaces without added capacity or other element of additional value. Such new or restored property shall not be valued in the accounts of the taxpayer as an amount in excess of the cost or value at March 1, 1913, if acquired before that date (after making proper provision in either case for depreciation to the date of the loss, damage or transfer), of the original property, plus the cost of any actual additions and betterments. If the taxpayer does not elect to replace or restore the property, the transaction will then be deemed to be completed and the income shall be measured by the excess of the amount of the compensation received over the cost of the property or its actual value at March 1, 1913, if acquired before that date (after making proper provision in either case for depreciation to the date of the loss, damage or transfer). See article 141. Articles 49 and 50 have no application to property which is voluntarily sold or disposed of. (Reg. 45, Art. 49. (1919.)

502 *Losses by Storms and Cost of Dividing Future Losses.*—A taxpayer's personal residence located on a beach was damaged by a storm, which washed away part of the foundation

and so undermined the building as to render its destruction certain if it was not immediately removed. In removing the building to a safer location it was further damaged.

The damage caused by the direct action of the storm and by the removal to avoid further probable damage is held to have arisen from storm and deductible from gross income as a loss within the meaning of section 214 (a) 6 of the Revenue Act of 1918. If the building was moved to prevent further loss from the storm in question, the expense of moving it is also deductible as a loss; but if it was moved to prevent probable losses from future storms, the expense of moving it is regarded as a capital expenditure and should be added to the cost of the building in computing profit in the event of its sale, since the removal to a safer locality presumably increased its value. (43—20—1259. O. D. 698.)

503 *Compensaton for Loss.*—Where business property was destroyed by fire and the taxpayer immediately replaced such property of substantially the same kind, the excess of the cost of replacement over the amount of insurance received as compensation for the property destroyed can not be taken as a loss. It is treated as a capital expenditure, which is recoverable through depreciation deductions. (43—20—1258. O. D. 697.)

504 *Losses.*—Losses sustained during the taxable year and not compensated for by insurance or otherwise are fully deductible (except by nonresident aliens) if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck or other casualty, or from theft. They must usually be evidenced by closed and completed transactions. In the case of the sale of assets the loss will be the difference between the cost thereof, less depreciation sustained since acquisition, or the fair market value as of March 1, 1913, if acquired before that date, less depreciation since sustained, and the price at which they were disposed of. See section 202 of the statute and articles 39-46 and 1561. When the loss is claimed through the destruction of property by fire, flood or other casualty, the amount deductible will be the difference between the fair market value of the property as of March 1, 1913, if acquired before that date, or if acquired on or after that date, its cost, and the salvage value thereof, after deducting from such cost, or such value as of March 1, 1913, the amount, if any, which has been or should have been set aside and deducted in the current year and previous years from gross income on account of depreciation and which has not been paid out in making good the depreciation sustained. But the loss should be reduced by the amount of any insurance or other compensation received. See articles 49 and 50. A loss in the sale of an individual's resi-

dence is not deductible. Losses in illegal transactions are not deductible. Where a person gives property away, or is divested thereof by death, no realization of loss results therefrom. (Reg. 45, Art. 141 (as amended by T. D. 2972, approved Feb. 7, 1920.)

505 *Replacement Fund for Loss.*—In any case in which the taxpayer elects to replace or restore the lost, damaged or transferred property, but where it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which the entire amount of the compensation so received shall be held, without deduction for the payment of any mortgage, and pending the disposition thereof the accounting for gain or loss thereupon may be deferred for a reasonable period of time, to be determined by the Commissioner. In such a case the taxpayer should make application to the Commissioner on form 1114 for permission to establish such a replacement fund and in his application should recite all the facts relating to the transaction and undertake that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require for an amount not less than the estimated additional income and war profits and excess profits taxes assessable by the United States upon the income so carried to the replacement fund. See section 1320 of the statute. The estimated additional taxes, for the amount of which the claimant is required to furnish security, should be computed at the rates at which the claimant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant and the surety or depositary may each have a copy. (Reg. 45, Art. 50. (1919.)

506 *Voluntary Removal of Buildings.*—Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements will be deductible from gross income in a sum representing the difference between the cost of such property demolished or scrapped and the amount of a reasonable allowance for the depreciation which the property had undergone prior to its demolition or scrapping that is to say, the deductible loss is only so much of the original cost of the property, less salvage, as would have remained unextinguished had a reasonable allowance been charged off for depreciation during each year prior to its destruction. When a taxpayer buys real estate upon which is located a building which he proceeds to

raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building. (Reg. 45, Art. 142. (1919.)

507 *Attorney's Fees for Securing Reduction of Assessment.*—The fees paid by a property owner to an attorney for his services in securing a reduction of an assessment imposed for a local benefit are not a proper deduction as a business expense. As such fees were paid to reduce a necessary capital expenditure in connection with the property against which the assessment was levied, they constitute a part of such capital expenditure, and hence are to be considered a part of the cost price of the property for the purpose of determining gain or loss in event of its sale. (48—20—1324—O. D. 739.)

508 *Taxes Paid by Tenant.*—Assessments for local benefits paid by a tenant for his landlord according to agreement are held to be additional rent paid by the tenant, and therefore deductible from his gross income, provided the tenant uses the property for business purposes. The amount so received by the landlord is taxable income to him, but because of its nature is not an allowable deduction from his gross income. (3—20—689. O. D. 373.)

509 *Bad Debts in Case of Mortgages.*—The proceeds obtained from a foreclosure sale of property which was encumbered by two mortgages were sufficient only to satisfy the first mortgage, and the question arises whether the second mortgage, which thereby becomes worthless, would, if charged off at its face value, be an allowable deduction under section 214 (a) 7 of the Revenue Act of 1918.

A mortgage is a security for a debt or obligation and an incident thereto; a debt or obligation of some kind is an essential element of a mortgage. (Carrol v. Tomlinson, 61 N. E. 484, 485.) A second mortgage is a mortgage without intervening liens between it and the first mortgage. (Appeal of Green, 97 Pa. 342, 347.) A creditor whose debt is secured by a mortgage has two remedies—one in personam for his debt, and the other in rem to subject the mortgaged property to its payment. (Silvey v. Axley, 23 S. E. 933.) Where a mortgage is given to secure the payment of a debt, the creditor may pursue his remedy either on the mortgage or on the evidence of the debt, or on both concurrently. (Ober v. Gallagher, 93 U. S. 199.) Where the proceeds of a foreclosure sale are not sufficient to satisfy the mortgage debt, the mortgagee

may thereafter maintain an action at law against the person liable for such deficiency. (Shepherd v. May, 115 U. S. 505.)

It is held, therefore, that since the mortgagee may maintain an action against the mortgagor for the amount of the debt, it is not sufficient, in order to deduct the amount as a bad debt, that he show only a failure of the security as the mortgagor may be solvent and the debt collectible, but he also must show that legal action against the mortgagor resulted in no recovery, or that such action would in all probability not result in the satisfaction of execution on a judgment. If the debt existed prior to March 1, 1913, only its value on that date may be deducted upon subsequently ascertaining it to be worthless. (42—20—1244. O. D. 687.)

510 *Compromise.*—Where an indebtedness is claimed and contested and a settlement is had by way of compromise whereby an amount, less than the debt claimed, is accepted in full payment and satisfaction of the debt, the difference between the amount paid and that claimed is not allowable as a deduction for bad debts. Where the settlement in compromise consists of a promise to pay an amount less than the debt claimed, the amount promised to be paid forms the basis of a new transaction, and upon failure to make good this promise the question will arise as to the deductibility of the new amount only. (Art. 8, Reg. 33, Rev., Jan. 2, 1918.)

511 *Forgiveness of Indebtedness.*—The cancellation and forgiveness of indebtedness is dependent on the circumstances for its effect. It may amount to a payment of income or to a gift or to a capital transaction. If, for exmple, an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. If a stockholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. If, however, a corporation to which a stockholder is indebted forgives the debt, the transaction has the effect of the payment of a dividend. See sections 213 (b) (3) and 240 of the statute and articles 543 and 631-638 (affiliated corporations). (Art. 51, Reg. 45, Rev., April 17, 1919.)

512 *Worthless Mortgage Debt.*—Where under foreclosure a mortgagee buys in the mortgage property and credits the indebtedness with the purchase price, the difference between the purchase price and the indebtedness will not be allowable as a deduction for a bad debt, for the property

which was security for the debt stands in the place of the debt. The determination of loss in such a situation is deferred until the property is disposed of, except where a purchase money mortgage is foreclosed by the vendor of the property. See article 46. Only where a purchaser for less than the debt is another than the mortgagee may the difference between the debt and the net proceeds from the sale be deducted as a bad debt. (Reg. 45, Art. 153. 1919.)

513 *Repairs.*—The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve. See articles 161-171. (Reg. 45, Art. 103 1919.)

514 *Incidental Repairs.*—The cost of incidental repairs which neither add to the value of the property, nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided that the plant or property account is not increased by the amount of such expenditures. Such repairs, to the extent that they arrest deterioration, should have the effect to reduce the depreciation charge otherwise deductible. (Art. 131, Reg. 33, Rev., Jan. 2, 1918.)

515 *Charitable Contributions.*—Contributions or gifts within the taxable year are deductible to an aggregate amount not in excess of fifteen per cent. of the taxpayer's net income, including such payments, if made (a) to corporations or associations of the kind exempted from tax by subdivision (6) of Section 231 of the statute, or, (b) to the special fund for vocational rehabilitation under the Vocational Rehabilitation Act of June 27, 1918. For a discussion of what corporations and associations are included within (a) see Article 517. A gift to a common agency (as a war chest) for several such corporations or associations is treated like a gift direct to them. In connection with claims for this deduction there shall be stated on returns of income the name and address of each organization to which a gift was made, and the approximate date and the amount of the gift in each case. (Where the gift is other than money the basis for calculation of the amount of the gift shall be the cost of the property, if acquired after February 28, 1913, or its fair market value as of March 1, 1913, if acquired prior thereto, after deducting from such cost or value the amount, if any, which has been or which should

have been set aside and deducted in the current year and previous years from gross income on account of depreciation, and which has not been paid out in making good the depreciation sustained. A gift of real estate to a city to be maintained perpetually as a public park is not allowable deduction.) The proportionate share of contributions made by a partnership to corporations or associations of the kind included in (a) above and to the special fund for vocational rehabilitation specified in (b) may be claimed as deductions in the personal returns of the partners to an amount which, added to the amount of such contributions made by the partner individually, is not in excess of fifteen per cent. of the partner's net income computed without the benefit of the deduction for such contributions. However, the contributions made by the partnership shall not be deducted from its gross income in ascertaining the amount of its net income to be reported on Form 1065 (revised). See article 321. This article does not apply to gifts by estates and trusts or corporations. See Section 219 of the statute and Articles 561 and 562.

This decision supersedes Treasury Decisions 2966 and 2977. (Reg. 45, Art. 251, as amended by T. D. 2998, approved April 10, 1920.)

516 *Carrying Charges as Part of the Cost of Property.*—The cost of property acquired subsequently to the incidence of the tax will be the actual price paid for it, together with the expense incident to the procurement of the property in the first instance and its sale thereafter, and the cost of improvements or development if any. (T. D. 2005, July 22, 1919.)

517 T. D. 2005 is not intended to be so construed that carrying charges, if they consist of such expenditures as constitute allowable deductions from gross income, are to be added to the cost of the property if there is a gross income from which such charges as constitute allowable deductions may be deducted. It is intended, however, that in the case of a holding or a developing company which has not yet reached the stage of having any income of consequence resulting from its corporate operations, the carrying charges or other excess over the incidental income received may be added to and made part of the cost of the property. (T. D. 2137, Jan. 30, 1915.)

518 *Cancellation of Lease.*—A business property was leased for a term of years, but prior to the termination of the lease the lessor paid a fixed sum to the lessee for its cancellation.

Held, that the amount so paid by the lessor constitutes a business expense and that he may deduct an aliquot part thereof in his return for the year in which the lease was canceled and for each succeeding year the lease had to run. (6—20—727. O. D. 397.)

519 *Bonus Paid for Lease.*—The amount of a bonus paid by a corporation to secure immediate possession of a theater under a lease which was limited to the taxable period, and attorneys' fees in connection with the transaction, constitute necessary business expenses or costs of operation for such period and are not required to be capitalized. (28—20—1054. A. R. 178.)

520 *Cost Connected with Title to Property Not Deductible.*—The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense........(Art. 293.)

521 *Cost of Materials.*—Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only to the amount that they are actually consumed and used in operation during the year for which the return is made, provided that the cost of such material and supplies has not been taken into account in determining the net income for any previous year. If a taxpayer carries materials or supplies on hand for which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to include in his expense and deduct from gross income the total cost of such supplies and materials as were purchased during the year for which the return is made, provided the net income is clearly reflected by this method. (Reg. 45, Art. 102, 1919.)

522 *Long Term Contracts.*—Persons engaged in contracting operations, who have uncompleted contracts, in some cases perhaps running for periods of several years, will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work; that is, on jobs which have been finally completed any and all moneys received in payment will be returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction from gross income should be limited to the expenditures made on account of such completed contracts. Or the percentage of profit from the contract may be estimated on the basis of percentage of completion, in which case the income to be returned each year during the performance of the contract will be computed upon the basis of the expenses incurred on such contract during the year; that is to say, if one-half of the estimated expenses necessary to the full performance of the contract are incurred during one year, one-half of the gross contract price should be returned as income for that year. Upon the completion of a contract if it is found that as a result of such estimate or apportionment the income of any year or years has been overstated or understated, the taxpayer should file amended returns for such year or years. See section 212 of the statute and articles 22-24. (Reg. 45, Art. 36, 1919.)

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